EDITOR'S NOTE

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ptember 30, 1985

Title: United States, Petitioner
v.
Hughes Properties, Inc.

Court: United States Court of Appeals for the Federal Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Lilienstern,O. Clayton

try	Date	Note	Proceedings and Orders
1	Jul 9 1985		Application for extension of time to file petition and order granting same until September 29, 1985 (Chief Justice, July 11, 1985).
2	Sep 30 1985	G	Petition for writ of certiorari filed.
3	Oct 30 1985		DISTRIBUTED. November 15, 1985
4	Oct 31 1985	X	Brief of respondent Hughes Properties Inc. in opposition filed.
5	Nov 14 1985	X	Reply brief of petitioner United States filed.
7	Nov 18 1985		REDISTRIBUTED. November 27, 1985
9	Dec 2 1985		Petition GRANTED.
			**********
1	Jan 13 1986		Order extending time to file brief of petitioner on the merits until January 30, 1986.
2	Jan 30 1986		Joint appendix filed.
3	Jan 30 1986		Brief of petitioner United States filed.
4	Feb 10 1986		Record filed.
5	Feb 13 1986		Record filed.
6	Feb 13 1986		Certified copy of briefs and appendix received.
7	Mar 1 1986		Brief amicus curiae of Atlantic City Casino Association filed.
8	Mar 3 1986		Brief amicus curiae of New York Life Insurance Co. filed.
9	Feb 28 1986		Brief of respondent Hughes Properties Inc. filed.
0	Mar 3 1986		Brief amicus curiae of Transamerica Corp. filed.
1	Mar 14 1986		SET FOR ARGUMENT, Wednesday, April 23, 1986. (2nd case)
2	Mar 14 1986		CIRCULATED.
3	Apr 11 1986	X	Reply brief of petitioner United States filed.
4	Apr 23 1986		ARGUED.

85-554

No.

Supreme Court, U.S.
FILED
SEP 30 1985
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTION PRESENTED

Whether a gambling casino using the accrual method of tax accounting may deduct amounts shown on the "jackpot indicators" of its progressive slot machines at the close of its taxable year, even though it has no obligation to pay those amounts unless and until the jackpots are won by its patrons in some future year.

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In the Supreme Court of the United States

OCTOBER TERM, 1985

No.

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-3a) is reported at 760 F.2d 1292. The opinion of the Claims Court (App., *infra*, 5a-20a) is reported at 5 Cl. Ct. 641.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 4a) was entered on May 2, 1985. On July 11, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and in-

cluding September 29, 1985 (a Sunday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 162, 446 and 461 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Section 1.461 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out in a statutory appendix (App., *infra*, 22a-24a).

STATEMENT

1. The relevant facts were stipulated (App., *infra*, 5a). Respondent Hughes Properties, Inc., is a Nevada corporation that owns Harolds Club, a gambling casino in Reno, Nevada (*id.* at 6a). During the tax years at issue, respondent operated "progressive slot machines" in its casino (*ibid.*). Like other slot machines, a "progressive" slot machine pays fixed amounts when certain combinations of apples, oranges or other symbols appear. Unlike other slot machines, however, a "progressive" machine also has an additional, "progressive" jackpot. This jackpot is initially set at a minimum amount determined by the casino (*id.* at 6a; C.A. App. 45-46). It automatically increases, according to a ratio determined by the casino, as money is gambled on the machine. The amount of the jackpot outstanding at any given time is registered on a meter, or "payoff indicator," on the face of the machine (App., *infra*, 6a-7a & n.2). This sum continues to increase as patrons gamble on the machine until the jackpot is won or until a maximum amount, again determined by the casino, is reached (*id.* at 6a). A progressive jackpot can be won only when a customer gambles the required amount of

money and the machine displays the winning combination of symbols (*ibid.*).

The odds of winning a progressive jackpot are a function of the number of reels on the machine, the number of positions on each reel where the reel may stop, and the number of winning symbols placed on each reel (App., *infra*, 6a; C.A. App. 46). The odds are determined by respondent; provided that there actually exists a possibility that the winning combination of symbols can appear, respondent's discretion in setting odds is unrestricted. By adjusting the odds, respondent can determine, within limitations prescribed by the law of averages, the frequency with which any particular progressive slot machine will pay off. In a 1976 study of 24 representative machines, respondent ascertained that one machine had been in operation for 13 months without a payoff, that another machine had been in operation for 35 months without a payoff, and that the payoff frequency of the other 22 machines ranged from a high of 14.3 months to a low of 1.9 months (App., *infra*, 7a n.1).

2. In September 1972 the Nevada Gaming Commission promulgated a rule that, for the first time, regulated the use of progressive slot machines by licensed casinos. Nev. Gaming Reg. § 5.110 (reprinted in App., *infra*, 7a-9a nn. 2 & 3). The rule requires gaming establishments to maintain daily records of the progressive jackpot amounts registered on each machine (Nev. Gaming Reg. § 5.110(5)). It directs that "[n]o payoff indicator shall be turned back to a lesser amount" unless the progressive jackpot is won by a customer, or unless "the change in

the indicator reading is necessitated through a machine malfunction" (*id.* § 5.110(2)). In the latter event, a report explaining the reduction in the payoff indicator must be filed (*id.* § 5.110(5)). This rule is strictly enforced by the Gaming Commission, which is authorized to impose sanctions (including license revocation) on casinos that wrongfully refuse to pay a progressive jackpot to a winning customer or that otherwise breach the Commission's rules (App., *infra*, 9a).

The Gaming Commission rule described above applies to all Nevada casinos so long as they remain in the gaming business (C.A. App. 59). If a casino were to go out of business, to surrender its gaming license, or to enter bankruptcy proceedings, it would no longer be subject to the rule and would be free to reduce or eliminate the amounts shown on its progressive jackpot indicators (*id.* at 58-59). The rule does not address the treatment of progressive slot machines in the event of the sale or other disposition of a gaming business. During the tax years in question, the Gaming Commission's unwritten policy in such circumstances was apparently to require the buyer to continue the progressive slot machines in play, without reduction of the payoff indicators (*id.* at 58). Whether the sales price would be adjusted to reflect that requirement, however, was a matter of negotiation between the buyer and the seller (*ibid.*).

3. Respondent uses the accrual method of accounting for federal tax purposes. In compliance with the Gaming Commission rule described above, respondent recorded the meter readings shown on its progressive slot machines every day and made no impermissible reductions of the machines' payoff indicators (App., *infra*, 9a). At midnight on the last day of its fiscal tax year, respondent entered the unpaid jackpot

amounts shown on those indicators as an "accrued liability" on its books (*ibid.*). From that total, respondent subtracted the previous year's accrued jackpot liability to produce a "net accrued liability" for the tax year in question (*id.* at 10a). On its federal income tax returns for 1973-1977, respondent deducted the latter amounts under Section 162 of the Code[1] as "ordinary and necessary [business] expenses paid or incurred during the taxable year."

On audit, the Commissioner disallowed the claimed deductions. Under the accrual method of tax accounting, he noted, an expense may not be deducted until "all of the events have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)). The Commissioner determined that the events which would fix respondent's liability to pay a progressive jackpot would be some lucky patron's pull of the handle, and the consequent appearance of the winning symbols on the slot machine, in some future tax year. Until those events occurred, the Commissioner concluded, respondent's obligation to pay the jackpots was contingent and thus gave rise to no deductible expense (App., *infra*, 10a). The Commissioner accordingly determined a deficiency in respondent's income tax in the amount of $433,000 for the tax years at issue (*id.* at 1a, 21a).

4. Respondent paid the asserted deficiency and, following the denial of its administrative claim for refund, filed this refund suit in the Claims Court. That court ruled for respondent. It concluded that, under the Nevada Gaming Commission rule described above, respondent's liability to pay the amounts

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the tax years at issue (the Code or I.R.C.).

shown on the progressive jackpot indicators became "unconditionally fixed" (App., *infra*, 14a) on "midnight of the last day of the fiscal year" (*id.* at 19a). In the Claims Court's view, the last event necessary to fix respondent's liability for the progressive jackpots was "the last play (successful or not) of the machine before the close of the fiscal year, that is, the last change in the jackpot amount before the amount is recorded for accounting purposes" (*id.* at 13a). "The winning handle pull," the court said, would "only determine[] the fortunate gambler in whose favor the liability [would be] enforced" (*id.* at 14a) (original quotation marks omitted)). The court seemed to acknowledge that if respondent "were to close its doors and go out of business, * * * it would not owe the jackpots to anybody" (*id.* at 15a (original quotation marks omitted)). But "[e]ven if the progressive slot machines were to never pay off," the court reasoned, "the set jackpot amounts indicated on the face of the machine[s] would still continue to be an *incurred* liability fixed by state law" (*id.* at 14a (emphasis in original)). The court "respectfully declined to follow" (*id.* at 15a) the Ninth Circuit's contrary decision in *Nightingale* v. *United States*, 684 F.2d 611 (1982).

The Federal Circuit affirmed (App., *infra*, 1a-3a). It acknowledged (*id.* at 2a) that the Claims Court had "declined to follow the contrary conclusion of the Ninth Circuit" in *Nightingale* v. *United States*, *supra*. However, without further discussing that decision or the reasoning that the Ninth Circuit there advanced, the court of appeals "affirm[ed] on the basis of the * * * Claims Court opinion," concluding that the trial judge had "carefully examined all of the arguments raised on the present appeal" (App., *infra*, 3a).

REASONS FOR GRANTING THE PETITION

The court of appeals has decided an important question of federal tax law in a way that conflicts directly with a recent decision of the Ninth Circuit. The reasoning of the opinion below is squarely at odds with fundamental principles enunciated by this Court to govern accrual of deductions under the "all events" test of tax accounting. The decision below produces an irrational result, for it permits respondent to take current tax deductions for amounts to which no one can assert any present claim and which respondent may never have to pay at all. The revenue impact of the decision below, rendered by a court of nationwide jurisdiction, would be substantial even if confined to the casino industry. But it is by no means clear that its effect would be so limited. The "all events" test is one of the most frequently-recurring concepts in tax law, and the Federal Circuit's erroneous construction of that test could be pressed into service by taxpayers seeking to take current deductions for almost any sort of contingent future liability. Review by this Court is therefore appropriate.

1. The decision below, as the Federal Circuit acknowledged (App., *infra*, 2a), squarely conflicts with the Ninth Circuit's decision, on virtually identical facts, in *Nightingale* v. *United States*, 684 F.2d 611 (1982). Like respondent, the taxpayer there was a Nevada gambling casino that used the accrual method of tax accounting (684 F.2d at 612). Like respondent, it sought to deduct unpaid amounts shown on the jackpot indicators of its progressive slot machines as "accrued liabilities" at the close of its tax year (*ibid.*). Like respondent, it was subject to the Nevada Gaming Commission rule prohibiting casinos

from turning back the payoff indicators on their slot machines (*id.* at 612-613). And like respondent, it contended that the year-end amounts shown on those indicators in consequence were "fixed liabilities" justifying deduction under the "all events" test of tax accounting, despite the fact that the jackpots had not yet been won by any player (*id.* at 613) .

The Ninth Circuit unanimously rejected the casino's argument. Notwithstanding the Gaming Commission rule, the court held, "[i]t [was] not true * * * that 'all events ha[d] occurred which determine[d] the fact of the liability' " at the close of the casino's tax year (684 F.2d at 614, quoting Treas. Reg. § 1.461-1(a)(2)). Rather, as the Ninth Circuit saw it (684 F.2d at 614):

> The one, indispensable such event is the winning of the progressive jackpot by some fortunate gambler. Until that event occurs, no actual liability has been incurred. Gambling being what it is, and gambling odds being what they are, it is entirely possible that no actual liability will ever occur. And if we assume that it is bound to occur some day, there is no way of knowing when that will be. The record shows that it may be four years hence.

If the casino "were to close its doors and go out of business," the court observed, "it would not owe the jackpots to anybody," a fact that "tend[ed] to show that there [was] no present liability" (684 F.2d at 615). Because the casino's liability on each slot machine was "contingent upon a winning pull," an event that "is most naturally regarded as a condition precedent" to the creation of a fixed obligation, the Ninth Circuit refused to permit deduction of progressive

slot machine jackpots before they are actually won by a customer (*id.* at 614-615).

2. In declining to follow the Ninth Circuit's reasoning, the Federal Circuit ignored basic principles of tax accounting enunciated long ago by this Court and subsequently embodied in the Treasury Regulations. The Code generally permits taxpayers to compute taxable income under either the "cash receipts and disbursements method" or the "accrual method" of tax accounting (I.R.C. § 446(c)(1) and (2)). Cash-method taxpayers may deduct expenses only in the year paid (Treas. Reg. §§ 1.446-1(c)(1)(i), 1.461-1(a)(1)). Accrual-method taxpayers, by contrast, are entitled to deduct expenses in the year "incurred," even though actual payment is deferred until a subsequent year. *E.g.*, I.R.C. § 162(a); see Treas. Reg. §§ 1.446-1(c)(1)(ii), 1.461-1(a)(2). It is well settled that " 'to incur' means to become liable or subject to.' " *Ox Fibre Brush Co.* v. *Blair*, 32 F.2d 42, 47 (4th Cir. 1929), aff'd *sub nom. Lucas* v. *Ox Fibre Brush Co.*, 281 U.S. 115 (1930). "[A] thing for which there exists no obligation to pay, either express or implied, cannot in law be claimed to constitute an 'expense incurred.' " *United States* v. *St. Paul Mercury Indemnity Co.*, 238 F.2d 594, 598 (8th Cir. 1956).

For more than fifty years, the standard for determining when an item of expense is to be regarded as "incurred," and hence as being properly deductible for federal tax purposes, has been the "all events" test. First articulated by this Court in *United States* v. *Anderson*, 269 U.S. 422, 424 (1926), the test was subsequently incorporated in the Treasury Regulations. It has two elements, both of which must be satisfied before accrual of an expense is proper.

First, "all the events [must] have occurred which establish the fact of the liability giving rise to [the] deduction" (Treas. Reg. § 1.446-1(c)(1)(ii)). Second, the amount of the deduction must be "determin[able] with reasonable accuracy" (*ibid.*). While the second part of the test permits a degree of computational flexibility, the Regulations emphasize that the first part of the test is absolute: "no accrual shall be made in any case [unless] all of the events have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)).

In determining whether a liability has become "fixed," and thus constitutes an "expense incurred during the taxable year" for federal tax purposes, this Court early made clear that "a liability does not accrue as long as it remains contingent." *Brown* v. *Helvering*, 291 U.S. 193, 200 (1934). "The prudent businessman," Justice Brandeis wrote for the Court, "often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas* v. *American Code Co.*, 280 U.S. 445, 452 (1930) (footnote omitted). To be deductible for tax purposes, the liability must be "unconditional." *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930). It must be "fixed and absolute." *Brown* v. *Helvering*, 291 U.S. at 201. "[T]he tax law requires," in short, "that a deduction be deferred until all the events have occurred that will make it fixed and certain." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 543 (1979) (original quotation marks omitted).

Respondent's liability for the progressive slot machine jackpots was plainly not "fixed and certain," was plainly not "unconditional" or "absolute," at midnight on the last day of its taxable year. At that moment, there existed no person at all who could assert any possible claim to those sums. If respondent

the following morning were to have closed its doors, sold its business, or entered bankruptcy, or if its patrons were to have ceased playing the slot machines, respondent would have had no liability, and would never have had any liability, to pay the jackpots to anyone—a fact that clearly demonstrates the conditional status of its obligation the night before. Respondent's obligation was in the nature of the offer of a prize, a prize that might be won if and when some future patron paid his money and plucked the winning combination of stars, bars, and fruit. So long as respondent chose to stay in the gambling business, of course, this offer was required to be irrevocable. But respondent's *liability* on the offer was nevertheless contingent. One does not have an "unconditional liability" unless there exists some person to whom he is liable, and respondent was not liable to anyone until somebody won the jackpot.

Contrary to the Federal Circuit's belief, the Nevada Gaming Commission rule concerning progressive slot machines does not alter the conditional nature of respondent's obligation. That rule simply sets a floor beneath the *amount* of respondent's liability, while leaving the liability itself contingent. The rule provides that the dollar amount of the jackpot respondent offers can never ratchet down, but must always stay the same or ratchet up; it dictates that respondent's liability, if and when it is incurred, will be in an amount proportional to the number of times the machine has previously been played. But the rule does not require respondent to pay a jackpot unless and until it is won by a customer. The rule thus leaves respondent's year-end liability in exactly the same contingent state that it was in before the Gaming Commission began regulating progressive slot machines in September 1972.

If respondent did have a fixed rather than a contingent liability at the close of its tax year, of course, the Gaming Commission rule could well permit the casino to satisfy the *second* prong of the "all events" test. Given the existence of that rule, arguably, "the amount [of respondent's year-end liability could] be determined with reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)). Respondent, however, did not have a fixed liability at that time, and the Gaming Commission rule makes no difference in determining whether this first, and essential, component of the "all events" test has been satisfied.

3. In permitting respondent to take a current deduction for a contingent future loss, the decision below also conflicts in fundamental principle with this Court's decisions emphasizing the critical differences between tax and financial accounting. As the Claims Court noted (App., *infra*, 11a), taxable income is generally computed "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books" (I.R.C. § 446(a)). Section 446(b), however, sets forth an exception to this rule, providing that, if the accounting method used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." The Regulations categorically state that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." Treas. Reg. § 1.446-1(a)(2).

Section 446 and its implementing Regulations obviously "vest the Commissioner with wide discretion in determining whether a particular method of * * * accounting should be disallowed." *Thor Power Tool*

Co., 439 U.S. at 532. This Court early noted that the general rule permitting use of the taxpayer's usual accounting practice "is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income." *Lucas* v. *American Code Co.*, 280 U.S. at 449. And the Court recently reaffirmed that the Commissioner in the accounting area has " '[m]uch latitude for discretion' " and that "his interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.' " *Thor Power Tool Co.*, 439 U.S. at 532 (quoting *Lucas* v. *American Code Co.*, 280 U.S. at 449).

Congress's decision to grant the Commissioner "broad powers" (*Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959)) to depart from the taxpayer's accounting practice in computing taxable income owes to "the vastly different objectives that financial and tax accounting have." *Thor Power Tool Co.*, 439 U.S. at 542. "The primary goal of financial accounting is to provide useful information to management, shareholders, [and] creditors" and "to protect these parties from being misled" (*ibid.*). Financial accounting accordingly "has as its foundation the principle of conservatism, with its corollary that possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income" (*ibid.*; original quotation marks omitted). "[T]he major responsibility of the Internal Revenue Service," by contrast, "is to protect the public fisc," so that "understatement of income is not destined to be its guiding light" (*ibid.*). Thus, whereas financial accounting "typically require[s] that a liability be accrued as soon as it can reasonably be estimated," the tax law mandates "that a deduction be deferred

until all the events have occurred that will make it fixed and certain" (*id.* at 543 (original quotation marks and footnote omitted)). "Indeed, th[is] Court's cases demonstrate that divergence between tax and financial accounting is especially common when a taxpayer seeks a current deduction for estimated future expenses or losses" (*id.* at 541 (citing cases)).

The court of appeals departed from these well-established principles in sustaining respondent's deduction. It may well be, as respondent's witnesses testified below, that the year-end accrual of its contingent slot machine liabilities "conform[ed] with generally accepted accounting principles" (C.A. App. 42). There was a probability, gambling being what it is, that respondent would eventually incur liability for its progressive slot machine jackpots. Although the timing of that liability's incurrence was largely within respondent's control, subject as it was to respondent's discretion in setting odds, there was also a mathematical possibility that the liability might be incurred the very next day. Thus, "the principle of conservatism" (*Thor Power Tool Co.*, 439 U.S. at 542) may well have required respondent to set up a reserve for those items at once and show them as a liability on its books. "[B]ut the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes" (*id.* at 543). Although "estimates, probabilities, and reasonable certainties * * * may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health," the tax law, "with its mandate to preserve the revenue, can give no quarter to uncertainty" (*ibid.*). "Only a few reserves voluntarily established as a matter of conservative accounting are authorized

by the Revenue Acts." *Brown* v. *Helvering*, 291 U.S. at 201-202 (Brandeis, J.) (quoted in *Thor Power Tool Co.*, 439 U.S. at 543-544). A reserve for contingent slot machine liabilities is not among those so authorized.

In sustaining respondent's deduction, finally, the court of appeals ignored this Court's warning about the "potential for tax avoidance" (*Thor Power Tool Co.*, 439 U.S. at 538) inherent in accounting techniques of the sort involved here. As the Ninth Circuit observed in *Nightingale*, casinos on respondent's theory could put new machines on the floor near the end of their tax year "with whatever initial jackpot they chose and with whatever odds they liked. Then they could take a current deduction for the full amount even though payment of the jackpots might not occur for many years" (684 F.2d at 615). "If management's election among [such] options were dispositive for tax purposes, a firm * * * could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay" for a particular tax year (*Thor Power Tool Co.*, 439 U.S. at 544). "Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable" (*ibid.*).

4. The question presented in this case has substantial administrative importance. We are advised by the IRS that there are currently pending administratively within its Nevada District 36 cases, entailing potential tax liabilities of about $28 million, that present the same question as the instant case. Furthermore, if the decision below is not reversed, the IRS anticipates that a number of other Nevada gambling casinos, which previously agreed to tax deficiencies after the Ninth Circuit rendered its deci-

sion in *Nightingale*, will file claims for refund. The aggregate amount of such refund claims is expected to equal or exceed the $28 million at issue in the 36 cases now pending administratively.

The above figures, moreover, do not take into account the impact of the Federal Circuit's decision on the casino industry in New Jersey. The IRS advises that the aggregate progressive slot machine liabilities of the New Jersey casino industry from its inception in 1978 through 1984 approximate $25 million. The IRS estimates that some $11 million in taxes is potentially at stake by reason of premature progressive jackpot accruals by New Jersey casinos.

As these numbers show, the revenue involved is considerable within the casino industry alone. The Federal Circuit's decision, however, could have an even more significant impact in other tax contexts. Many of this Nation's businesses use the accrual method of tax accounting, and the "all events" test is one of the most frequently-recurring concepts in tax law. The Federal Circuit's open-ended construction of the "fixed liability" component of that test could be pressed into service by accrual-basis taxpayers seeking current deductions for a host of contingent future liabilities—liabilities as diverse as employers' obligations on workmen's compensation claims and coal companies' obligations to restore strip-mined land. The Claims Court is a court of nationwide jurisdiction—any taxpayer in the country can have his case heard there, with review in the Federal Circuit, simply by filing a refund suit. Accrual-basis taxpayers can thus be expected to make vigorous attempts to extend the Federal Circuit's reasoning well beyond slot machines and the gaming industry.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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SEPTEMBER 1985

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

Appeal No. 85-503

HUGHES PROPERTIES, INC., APPELLEE

v.

THE UNITED STATES, APPELLANT

Decided: May 2, 1985

Before BENNETT, SMITH, and BISSELL, *Circuit Judges.*

BENNETT, *Circuit Judge.*

Appellant challenges the judgment of the United States Claims Court which granted Hughes Properties, Inc., an accrual basis taxpayer, a refund of $433,441.88 in federal income taxes plus assessed interest for the fiscal years ending on June 30 in 1973, 1974, 1975, and 1977. *Hughes Properties, Inc.* v. *United States*, 5 Cl. Ct. 641 (1984). We affirm.

The relevant facts in this case are stipulated. On cross-motions for summary judgment, the United States Claims Court * held that taxpayer had satis-

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* Judge Robert M. M. Seto.

fied the "all events" test required by Treas. Reg. § 1.461-1(a)(2) (1984). The court reasoned that as a result of section 5.110 of the Nevada Gaming Commission regulations on the use of progressive slot machines maintained by licensed casinos, taxpayer's liability to pay the amounts shown on the jackpot indicators was unconditionally fixed as of the close of the taxable year, notwithstanding the fact that no payment would occur unless and until a customer playing the machine actually achieved the winning combination of symbols. In so holding, the court declined to follow the contrary conclusion of the Ninth Circuit in *Nightingale* v. *United States*, 684 F.2d 611 (9th Cir. 1982).

Under the accrual method of accounting, an expense is deductible for a tax year in which all of the events have occurred that determine the fact of liability and the amount thereof can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii) (1984).

Here, liability of the taxpayer for the recorded amount of the guaranteed jackpot obligation was fixed and it satisfied the requirements for accrual of a deduction. Liability exists if there is an obligation to perform an act and the cost of performance can be measured in money. The commission regulation makes the guaranteed jackpot a fixed liability. This liability is not contingent upon the time of payment or the identity of the jackpot winner. The taxpayer's method of accounting accurately reflects the casino's income and expenses. If we were to require that the deduction of a jackpot liability be deferred until the year of actual payment, rather than the year in which the liability accrued, it would distort taxable income for the year of payment. Here, the accounting

method used by taxpayer results in allocation of the expense to the year in which the revenues were earned.

The Claims Court has carefully examined all of the arguments raised on the present appeal. We have reexamined those arguments, the briefs, statutes, regulations, and authorities, and conclude that the court was legally correct when it granted summary judgment to the taxpayer. We affirm on the basis of the United States Claims Court opinion.

Affirmed

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 85-503
594-82T

HUGHES PROPERTIES, INC., PLAINTIFF-APPELLEE

v.

THE UNITED STATES, DEFENDANT-APPELLANT

JUDGMENT

ON APPEAL from the U.S. Claims Court

This CAUSE having been heard and considered, it is

ORDERED and ADJUDGED: Affirmed.

Dated May 2, 1985

Entered By Order
of the Court

/s/ George E. Hutchinson
GEORGE E. HUTCHINSON
Clerk

Issued as a Mandate: June 18, 1985

APPENDIX C

IN THE UNITED STATES CLAIMS COURT

No. 594-82T

HUGHES PROPERTIES, INC.

v.

THE UNITED STATES

[Filed: June 29, 1984]

ON CROSS-MOTIONS
FOR SUMMARY JUDGMENT

OPINION

SETO, Judge:

This case is before the court on cross-motions for summary judgment with all relevant facts stipulated. The single issue before the court is whether certain liabilities, assertedly giving rise to the claimed deductions, have been fixed for the purpose of calculating federal income tax. For the reasons set forth below, the court concludes that plaintiff's motion should be granted and defendant's motion should be denied.

FACTS

Plaintiff, Hughes Properties, Inc., is a Nevada corporation which owns Harolds Club, a gambling casino located in Reno, Nevada. During the fiscal years ending on June 30 in 1973, 1974, 1975 and 1977, plaintiff owned and operated progressive slot machines in this gambling casino. A "progressive slot machine," like other, nonprogressive, slot machines, pays fixed jackpot amounts when specific combinations of symbols appear. Unlike other slot machines, however, a progressive slot machine also has an additional, "guaranteed," jackpot. This latter jackpot amount is initially set at a given minimum. The machine automatically increases, by a pre-set ratio, the amount of this jackpot as money is gambled on the machine, and displays that amount on a meter on the face of the machine. The amount will increase until the jackpot is won or until a maximum amount (predetermined by the casino) is reached. A "guaranteed" jackpot can be won only when (1) the customer gambles the required (and, usually, the maximum) amount of money *and* (2) the machine displays the correct combination of symbols.

During the taxable years in issue, plaintiff operated various types of progressive slot machines. These machines differ as to the number and value of coins that can be gambled by a customer and the number and size of the reels contained within a machine. In addition, some machines have two "guaranteed" jackpots, which alternate in availability with each pull of the handle. Because of the differences in types of machines, the odds of winning a jackpot vary. According to plaintiff's brief and pretrial sub-

mission, the average period between payoffs is approximately 4.5 months.[1]

In September 1972, the Nevada Gaming Commission promulgated Regulation § 5.110,[2] which, for the

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[1] "This determination was made as of September 1, 1976, for the twenty-four 4-reel progressive slot machines then in operation. All but two of these machines were installed prior to 1974. With the exception of two machines, one of which had been in operation for thirteen months and the other for thirty-five months, *that did not pay off* prior to September 1, 1976, the payoff frequency ranged from a high of 14.3 months to a low of 1.9 months." Plaintiff's brief at 4 (emphasis supplied). *See also* Transcript of Oral Argument, February 16, 1984, at 36.

[2] This regulation reads as follows:

Progressive Slot Machines
(As adopted September 1972)

1. This paragraph shall apply to any slot machine with a payoff indicator which has a payoff that increases as the machine is played.

2. No payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player, or unless the change in the indicator reading is necessitated through a machine malfunction, in which case an explanation must be entered on the daily report as required in subsection 5.

3. If the payoff indicator progresses without a payoff until the indicators return to zero, some means must be utilized to add another digit, unless a dollar limit has been posted on the machine clearly visible to the player, and which was posted before any payoff was registered on the indicator. When the limit has been reached it must be permitted to remain until won by a player.

4. Once a payoff amount appears on an indicator, the rate of progression may not be changed until there has been a winner, and the indicator is returned to zero.

5. Records shall be maintained which record the

first time, regulates the use of progressive slot machines maintained by licensed casinos. This regulation directs licensed gaming establishments to compile and maintain daily records indicating the "guaranteed" jackpot amounts registered on each machine. The regulation further states that the displayed jackpot amounts cannot be reduced unless the jackpot is either won by a customer, or the slot machine is taken off the casino floor for repairs. In the latter case, a report explaining the reasons for the removal must be filed. *See* Nevada Gaming Regulation § 5.110(2) (as adopted September 1972).[3]

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amount of the indicated payoff at least once per day. Supporting documents shall be maintained to explain any reduction in the payoff amount from the previous entry. Such records and documents shall be retained for a period of three years. . . .

[3] The regulation as set forth in note 2 *supra*, was amended on March 1, 1977. The amended regulation states in part that:

4. No payoff indicator shall be turned back to a lesser amount unless one of the following circumstances occur [*sic*]:

(a) The amount shown on the progressive meter is paid to a player as a jackpot; or

(b) It becomes necessary to adjust the progressive meter to prevent the jackpot indicator from displaying an amount greater than the limit imposed by the licensee pursuant to paragraph 2 of this regulation; or

(c) It becomes necessary to change the jackpot indicator because of machine malfunction, in which case an explanation must be entered on the daily report as required by . . . this regulation.

5. *Payoff required.* Once a payoff amount appears on a jackpot indicator, the progressive meter may not be decreased except as allowed by this regulation. A progressive jackpot may be transferred to another progressive machine at the same location in the event of machine malfunction, replacement, or for other good reason. When

Regulation § 5.110 is strictly enforced by the Nevada Gaming Commission (hereinafter "Commission"). *See* Affidavit of John H. Stratton, former member of Nevada Gaming Control Board, p. 2 at ¶ 4. The Commission is authorized by § 463.310 of the Nevada Revised Statutes to impose severe administrative sanctions (including license revocation) upon any casino that wrongfully refuses to pay a winning customer a "guaranteed" jackpot. Hence, once accumulated, a "guaranteed" jackpot cannot be lessened or eliminated except by a payoff.

In accordance with Regulation § 5.110(2), plaintiff recorded the meter readings on its progressive slot machines and did not decrease any of the progressive jackpot amounts except as allowed by the regulation. These meter readings provided the numerical data for the deductions taken by plaintiff and placed at issue here. The accrued but unpaid progressive slot machine jackpot amounts as reported by the plaintiff from 1973 to 1977 were:[4]

Fiscal Year Ended June 30	Accrued Liability	Expense (Income)
1973	$360,228.55	$360,228.55
1974	563,983.99	203,755.44
1975	853,584.22	289,600.23
1976	839,400.97	(14,183.25)
1977	888,820.67	49,419.70

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the maximum jackpot limit is reached, it must be permitted to remain until won by a player. (Emphasis supplied.)

The amendments to this regulation did not change the force or scope of this law [*sic*] and therefore do not affect this court's ruling.

[4] Plaintiff's brief at 6.

Plaintiff deducted as an ordinary and necessary business expense the *net* accrued liability for each fiscal year. The net accrued liability is determined by subtracting the previous year's accrued liability, which has already been deducted, from the current gross liability as indicated by the meter totals. For example, on midnight of the last day of fiscal year 1974, plaintiff's accountants totaled the figures appearing on the meters of the progressive slot machines and determined that their gross liability for that fiscal year was $563,983.99. Since plaintiff had already deducted $360,228.55 as a business expense in the previous fiscal year, the net accrued liability was $203,755.44. This is the amount that plaintiff reported as a deduction on its income tax returns for fiscal year 1974.

Although there is no dispute as to the *accuracy* of the amounts deducted by plaintiff,[5] the Internal Revenue Service ("IRS") denied plaintiff's deductions, claiming that the jackpot payoffs can only be deducted in the year actually paid because the jackpot amounts were merely a contingent liability. Defendant contends that these amounts are only deductible when actually won by a customer. Plaintiff sought a refund from the IRS after paying the assessed taxes and asserted that the accrued expense deductions were timely because the liability is fixed by Nevada state law. After plaintiff's request for a refund was denied, this suit was instituted.

DISCUSSION

Business expenses are deductible under the Internal Revenue Code, Title 26 of the United States Code (hereinafter "the Code" or "IRC"):

[5] Transcript of Oral Argument at 3-4.

> In general—there shall be allowed as a deduction all the *ordinary and necessary* expenses paid or incurred during the taxable year in carrying on any trade or business. . . . [IRC § 162(a) (Emphasis supplied).]

Defendant does not contest the deductibility *per se* of plaintiff's liability for the "guaranteed" jackpot amounts, but rather takes issue with the timing of those deductions. The timing of a deduction is determined with reference to IRC § 461(a), which states the general rule: "The amount of any deduction . . . shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income." Plaintiff computes its income by the accrual method of accounting, as allowed by subsections (a) and (c)(2) of § 446 of the Code. The pivotal question thus becomes whether plaintiff, in accruing the unpaid, "guaranteed" jackpots as liabilities, properly utilized the accrual method of accounting.

Treasury Regulation § 1.461-1(a)(2) explains the general rule for the timing of deductions by adopting a test first formulated by the Supreme Court in *United States v. Anderson*, 269 U.S. 422 (1926). This test, now known as the "all events" test, is stated as follows:

> [U]nder an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy.

The Court of Claims has accepted this test, restating it as follows:

> First, the taxpayer must show that the *fact of liability* is certain as of the end of the [fiscal] year in question. Second, the taxpayer must demonstrate that the amount of the liability can be reasonably ascertained. [*Eastman Kodak Company v. United States*, 209 Ct. Cl. 365, 375, 534 F.2d 252, 258 (1976) (Emphasis in original).]

When these two criteria are satisfied, the deduction must be allowed even though actual payment is deferred to a different fiscal year. *Clark v. Woodward Construction*, 179 F.2d 176 (10th Cir. 1950). *See also Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516, 519 (1944). To deny a deduction that has satisfied the test would be contrary to the intent of the regulation as well as to the fundamental accounting principle that accrual accounts immediately reflect expenses incurred without regard to the timing of actual payment.

In this action, defendant's counsel, during oral argument, stated that the accuracy of the amounts deducted by plaintiff is not in issue.[6] Defendant asserts, however, that the first prong of the "all events" test has not been satisfied. It specifically rejects plaintiff's argument that the jackpot liability was fixed, despite admitting that plaintiff is precluded from avoiding payment as a result of Nevada Gaming Commission Regulation § 5.110. To support its theory, defendant cites *Nightingale v. United States*, 684 F.2d 611 (9th Cir. 1982), a case also involving a Nevada gambling casino seeking to deduct accrued progressive slot machine jackpot amounts based upon

[6] Transcript of Oral Argument at 3-4 ("There is no dispute in this case as to the reasonable accuracy of the amounts.")

the theory that the liability was fixed by state law. In *Nightingale*, the Ninth Circuit denied the deduction for accrued but unpaid jackpot expenses because it found that the "all events" test had not been satisfied. The court held that:

> The one indispensable . . . event is the winning of the progressive jackpot by some fortunate gambler. * * * Gambling being what it is, and gambling odds being what they are, it is entirely possible that no actual liability will ever occur. * * * [T]here is no way of knowing when any particular 'one armed bandit' will pay off, nor what the amount of that payoff will then be. [684 F.2d at 614.]

The *Nightingale* court reasoned that without the "one indispensable . . . event," the liability for accumulated but unpaid jackpot amounts was contingent and therefore did not satisfy the first prong of the "all events" test.

The essential argument, therefore, concerns the last event necessary to satisfy the "all events" test. Defendant contends that this last event is the actual, winning handle pull. Plaintiff contends that the last event is the last play (successful or not) of the machine before the close of the fiscal year, that is, the last change in the jackpot amount before the amount is recorded for accounting purposes. We believe that the latter view is correct. In *Clark*, *supra*, the court stated: "The decisive factor is the creation of an enforceable liability." 179 F.2d at 177. In *Trinity Construction Co. v. United States*, 424 F.2d 302, 305 (5th Cir. 1970), it was held that: "Accrual of a deduction is permitted only in the taxable year when the obligation to pay it is unconditionally

fixed" (*citing Brown v. Helvering*, 291 U.S. 193 (1934); *Security Flour Mills Co. v. Commissioner of Internal Revenue*, 321 U.S. 281 (1944); and *Whitaker's Estate v. Commissioner of Internal Revenue*, 259 F.2d 379 (5th Cir. 1958)). At the end of plaintiff's fiscal year, plaintiff's obligation to pay out the recorded amount is "unconditionally fixed" by the terms of § 5.110. Under that regulation, the liability for the jackpot amount can be enforced by the Nevada Gaming Commission. The winning handle pull, on the other hand, only determines the "fortunate gambler" in whose favor the liability is enforced. That the identity of that "fortunate gambler" is unknown, that the exact time the jackpot will be won is unknown, or that the exact amount of the jackpot at the time it is won is unknown does not affect the certainty of the liability at the end of plaintiff's fiscal year; in other words, "when the liability itself is clearly fixed . . . other uncertainties do not necessarily destroy that initial certainty." *Washington Post Co. v. United States*, 186 Ct. Cl. 528, 536 (1969). In the fact setting before the court, the uncertainties listed above do not destroy the "initial certainty" of liability. Even if the progressive slot machines were to never pay off, the set jackpot amounts indicated on the face of the machine[s] would still continue to be an *incurred* liability fixed by state law, for which plaintiff would continue to be responsible. Plaintiff's deductions for the net accrued liability are proper.

We further observe that, were the actual winning handle pull held to be the last event necessary to satisfy the "all events" test, the effect of such a holding would be to convert plaintiff, at least in this

instance, from an *accrual* basis taxpayer to a *cash* basis taxpayer. In the absence of the gaming commission's regulation, this might be a necessary step in order to ensure that plaintiff's method of accounting accurately reflected its financial status, inasmuch as plaintiff's liability for jackpots could not be known until a jackpot had been won. Because the regulation makes the jackpot amounts enforceable liabilities, however, plaintiff should be allowed to use a method of accounting that clearly reflects the existence of those liabilities for the period during which the liabilities were incurred. The court is satisfied that plaintiff's deduction of *net* accrued liabilities accomplishes this goal.

Were this the whole import of the *Nightingale* decision, this court, having respectfully declined to follow that decision, would have no need to continue. The *Nightingale* court, however, listed three other factors in support of its decision which we, again respectfully, reject. First, the *Nightingale* court stated that "[i]f the [casino] . . . were to close its doors and go out of business, . . . it would not owe the jackpots to anybody. This tends to show that there is no present liability." 684 F.2d at 615. This is a misstatement of the consequences. If the casino were to be relieved of the responsibility of paying off the slot machine jackpots which have already been deducted, the amounts displayed on the meters would constitute income. *See* IRC § 61(a); *Alice Phelan Sullivan Corporation v. United States*, 180 Ct. Cl. 659 (1967) (return or recovery of property that was once subject to a deduction must be treated as income in the year of its recovery). *See also Putoma Corp. v. Commissioner*, 601 F.2d 734, 741 (5th Cir. 1979).

The *Nightingale* court also appeared to be concerned that a Pandora's box would be opened if the deductions sought in that case were allowed. The concern was that accrual basis casinos would be able to avoid paying taxes simply by placing additional progressive slot machines set with very high initial jackpot amounts on their casino floors on the very last day of the fiscal year. This concern is obviated by the provisions of § 446(b) of the Code: "[I]f the method used [to compute taxable income] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." The Court of Claims has upheld, in no uncertain terms, the Commissioner's powers under this section:

> [Defendant] is no doubt correct in its position that the Commissioner has broad discretion to modify a taxpayer's accounting method to insure a clear reflection of income. *See Commissioner v. Hansen*, 360 U.S. 446, 467 (1959); *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930). Even where the taxpayer's accounting method complies with generally accepted principles, the Commissioner may reject it if he determines that it does not clearly reflect the taxpayer's income. *American Automobile Assoc. v. United States*, 367 U.S. 687, 692, 695 (1961). And in challenging the Commissioner's determination, the taxpayer has a heavy burden of proof to show a clear abuse of discretion. *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 284 (1967). [*Clement, et al. v. United States*, 217 Ct. Cl. 495, 509-510 (1978) (*per curiam*), *cert. denied*, 440 U.S. 907 (1979).]

The court also held that the Commissioner may modify not only the taxpayer's method, but also any particular item therein that distorts income: "It is settled that the Commissioner has discretionary authority to disallow a particular deduction on the ground that the timing of the payment distorts income." *Id.* at 510, *citing Burck v. Commissioner*, 533 F.2d 768, 773 (2d Cir. 1976) and *Sandor v. Commissioner*, 62 T.C. 469, 476-477 (1974), *aff'd*, 536 F.2d 874 (9th Cir. 1976). As evidenced by the decision in *Clement*, *supra*, this court will not hesitate to uphold the Commissioner's efforts to eradicate fraudulent practices, but, where no such practice has been alleged or proven and where the court has found that the timing of the deduction does not distort income, the court will not act on mere speculation.

One last issue that the *Nightingale* court addressed was its concern that the casino was deducting an expense that was not being matched in the current taxable year with the income of a winning customer. "To allow a deduction for an accrued expense would be to allow a deduction where there will be no corresponding income for perhaps four years or longer. Until then (the actual winning of the jackpot) there can be no accrual [sic] of income. . . ."[7] 684 F.2d at 615. The court's use of the word "accrual" is unclear here—moreover, it is *not* required that there be any matching of income and expense between two different taxpayers. The Court of Claims has declared that in a transaction between an accrual basis taxpayer and a cash basis taxpayer, the former is

---

[7] The problem that the *Nightingale* court does not address is that accrued income is *always* subject to tax.

obligated to recognize expenses when the "all events" test is met, while the latter must only report income actually or constructively received. *Campbell v. United States*, 228 Ct. Cl. 661, 675 (1981). It is therefore irrelevant that there is no matching of income and expense between Harolds Club and its customers.

Defendant additionally avers that the tax court opinion in *World Airways, Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977), supports its position that the first prong of the "all events" test has not been met by plaintiff. We disagree. The facts in *World Airways* showed that the plaintiff deducted estimated costs for future overhauls of its aircraft engines and airframes. Plaintiff argued that it was under contractual obligations to pay these costs and, thus, the liability was "fixed." The deduction was denied by the tax court because the expense was a contingent liability. The tax court held that the contracts merely obligated the *performance* of the overhauls at a future date and the plaintiff was under no obligation to pay until an overhaul was actually performed. 62 T.C. at 802. In the instant case, it is payment, not performance, that is obligated.

The liability was not found to be "fixed" in *World Airways* because the contracts could have been modified *at any time* by the parties; the contracts in that case "did *not* fix the fact of [plaintiff's] liability for the amounts accrued." *Id.* (Emphasis supplied.) If the deductions taken in *World Airways* were allowed, a deduction would have been permitted for an expenditure that might have never occurred. In the present case, the liability is *unconditionally fixed* by § 463.310 of the Nevada Revised Statutes which gives

full force and effect to Nevada Gaming Regulation § 5.110. *See* text, *supra*. In this action, the "guaranteed" jackpot liability becomes fixed for the taxable year on midnight of the last day of the fiscal year. Because "the accrual of a deduction item is permitted only in the taxable year when the obligation to pay it is unconditionally fixed," *id.*, this court is compelled to allow the deductions taken by Harolds Club.

The "all events" test, because it is to be applied to the particular facts presented in each different circumstance, must be applied on an *ad hoc* basis. The test is designed to aid taxpayers and the courts in determining when an accrued expense may be deducted, and to prevent various forms of tax evasion by preventing the deduction of contingent liabilities. It is clear that the IRS will not allow taxpayers to alter their tax liabilities *sua sponte* by deducting contingent liabilities. In the present case, however, only the Nevada State Legislature can alter the "guaranteed" jackpot liabilities of the casinos in that state. Under this circumstance, the claimed deduction satisfies the requirements of the "all events" test. The deduction is therefore a valid one under an accrual method of accounting, and should be allowed.

CONCLUSION

Based upon the foregoing discussion, this court concludes that the deductions taken by Harolds Club were timely. Therefore, defendant's motion for summary judgment is DISMISSED [*sic*], and plaintiff's motion for summary judgment is GRANTED.

The parties are hereby directed to submit to the court a joint stipulation as to the amount of the tax refund no later than July 30, 1984. Upon receipt of

such stipulation, the Clerk of the Court shall enter judgment for plaintiff accordingly.

IT IS SO ORDERED.

/s/ Robert M. M. Seto
ROBERT M. M. SETO
Judge

APPENDIX D

IN THE UNITED STATES CLAIMS COURT

No. 594-82T

HUGHES PROPERTIES, INC.

v.

THE UNITED STATES

[Filed: Aug. 1, 1984]

JUDGMENT

Pursuant to the order of June 29, 1984, and the stipulation filed by the parties on July 30, 1984,

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiff recover of and from the United States the amounts as listed below, plus statutory interest:

Taxable Year Ending	Tax Refund Due
June 30, 1973	$172,909.70
June 30, 1974	97,802.61
June 30, 1975	139,008.11
June 30, 1977	23,721.46

Frank T. Peartree
Clerk of Court

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the years at issue:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

* * * * *

SEC. 446. GENERAL RULE FOR METHOD OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

* * * * *

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

* * * * *

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.461-1 *General rule for taxable year of deduction.*

(a) *General rule.*—

* * * * *

(2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can

be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461-2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

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Supreme Court, U.S.
FILED
OCT 31 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-554

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPERTIES, INC.,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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BEST AVAILABLE COPY

I

QUESTION PRESENTED

Whether the Court of Appeals correctly determined that Hughes Properties, Inc., an accrual basis taxpayer engaged in the business of gaming, may deduct for federal income tax purposes its accrued but unpaid liability for progressive slot machine jackpots.

PARTIES

Petitioner is the United States of America. Respondent is Hughes Properties, Inc., which does not have a parent company, subsidiaries (except for Harolds Club, Inc., a wholly owned inactive subsidiary), or any affiliates.

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§ 463.310.4	8
Treas. Reg. (26 C.F.R.):	
§ 1.446-1(c)(1)(ii)	2
§ 1.451-1(a)	13
§ 1.461-1(a)(2)	6, 11, 13, 18
Nev. Gaming Reg. (1972):	
§ 5.110	2, 3, 4, 5, 7

No. 85-554

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPERTIES, INC.,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondent Hughes Propertes, Inc. respectfully prays that the Petition for Writ of Certiorari to review the judgment and opinion of the United States Court of Appeals for the Federal Circuit entered in this action on May 2, 1985 be denied.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved in this case that are not set forth in the statutory appendix to the Petition for Certiorari are Section 1.446-1(c)(1)(ii) of the Treasury Regulations on Income Tax (26 C.F.R.), Section 463.310 of the Nevada Revised Statutes, and Section 5.110 of the Nevada Gaming Regulations and are included in the appendix (App., *infra,* 1a-5a).

STATEMENT OF THE CASE

Additional facts of the case that clarify and supplement the factual summation set forth in the Petition for Certiorari may be summarized as follows:

During the taxable years in issue, respondent owned and operated various types of progressive slot machines. Those machines differed as to the number and value of coins that can be gambled by a customer and the number and size of the reels contained within a machine. Because of the differences in types of machines, the odds of winning a "guaranteed" jackpot vary. The average period between payoffs is approximately 4.5 months (Pet. App. 6-7a). All of respondent's accrued but unpaid progressive slot machine jackpots as of June 30, 1977, the close of the last taxable year in issue, were subsequently won by and paid to customers of respondent (C.A. App. 113).

The Nevada Gaming Commission, which promulgated Nevada Gaming Regulation § 5.110, strictly enforces Regulation § 5.110. Section 463.310 of the Nevada Revised Statutes ("N.R.S.") authorizes the Nevada Gaming Commission to impose severe administrative sanctions (including license revocation and fines up to $100,000)

upon any licensed gaming establishment that wrongfully refuses to pay a winning customer a "guaranteed" jackpot. Once accumulated, a "guaranteed" jackpot cannot be reduced or eliminated except by a payoff (Pet. App. 9a).

The meter readings on its progressive slot machines that respondent recorded daily in accordance with Nevada Gaming Regulation § 5.110 provided the numerical data for the deductions taken by respondent. The accrued but unpaid progressive slot machine jackpot amounts as reported by the respondent from 1973 to 1977 were:

Fiscal Year Ended June 30	*Accrued Liability*	*Deduction (Income)*
1973	$360,228.55	$360,228.55
1974	563,983.99	203,755.44
1975	853,584.22	289,600.23
1976	839,400.97	(14,183.25)
1977	888,820.67	49,419.70

(Pet. App. 9a).

Respondent deducted as an ordinary and necessary business expense under Section 162 of the Code[1] the net accrued liability for each fiscal year. The net accrued liability is determined by subtracting the previous year's accrued liability, which has already been deducted, from the current gross liability as indicated by the meter totals. For example, on the last day of fiscal year 1974, respondent's accountants totaled the figures appearing on the meters of the progressive slot machines and determined that their gross liability for that fiscal year was $563,983.99. Because respondent had already deducted

1. Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the tax years at issue (the "Code").

$360,228.55 as a business expense in the previous fiscal year, the net accrued liability was $203,755.44. This is the amount that respondent reported as a deduction on its income tax for fiscal year 1974 (Pet. App. 10a).

Although there was no dispute as to the accuracy of the amounts deducted by the respondent, the Commissioner claimed that the "guaranteed" jackpot payoffs could only be deducted in the year actually paid because the "guaranteed" jackpot amounts were merely a contingent liability (Pet. App. 10a). The Commissioner determined a deficiency in respondent's income tax in the amount of $433,441.88 for the tax years in issue (Pet. App. 1a). Respondent sought a refund after paying the assessed taxes and asserted that the accrued expense deductions were timely because the liability was fixed by Nevada state law. After respondent's request for a refund was denied, suit was instituted (Pet. App. 10a).

The Claims Court noted that petitioner "does not contest the deductibility per se of [respondent's] liability for the guaranteed jackpot amounts, but rather takes issue with the timing of those deductions" (Pet. App. 11a) (original quotation marks omitted). Petitioner "specifically rejects [respondent's] argument that the jackpot liability was fixed," the Claims Court stated, *"despite admitting that [respondent] is precluded from avoiding payment as a result of Nevada Gaming Commission Regulation § 5.110"* (Pet. App. 12a) (emphasis added). The Claims Court held:

> [A]t the end of [respondent's] fiscal year, [respondent's] obligation to pay out the recorded amount is "unconditionally fixed" by the terms of § 5.110. Under that regulation, the liability for the jackpot amount can be enforced by the Nevada Gaming Commission. . . . That the identity of that fortunate gambler is unknown, that the exact time the jackpot will be won is unknown, or that the exact amount of the jackpot at the time it is won is unknown does not affect the certainty of the liability at the end of [respondent's] fiscal year. . . . In the fact setting before the court, the uncertainties listed above do not destroy the initial certainty of liability.

Pet. App. 14a.

The Claims Court further observed that, "were the actual winning handle pull held to be the last event necessary to satisfy the all events test, the effect of such a holding would be to convert [respondent], at least in this instance, from, an *accrual* basis taxpayer to a *cash* basis taxpayer" (Pet. App. 14-15a). The Claims Court acknowledged that it "will not hesitate to uphold the Commissioner's efforts to eradicate fraudulent practices, but, where no such practice has been alleged or proven and where the court has found that the timing of the deduction does not distort income, the court will not act on mere speculation" (Pet. App. 17a). Therefore, the Claims Court held that "the liability is *unconditionally fixed* by § 463.310 of the Nevada Revised Statutes which gives full force and effect to Nevada Gaming Regulation § 5.110" (Pet. App. 18a-19a) (emphasis in original).

The Court of Appeals "reexamined those arguments, the briefs, statutes, regulations, and authorities and conclude[d] that the [Claims Court] was legally correct when it granted summary judgment to the taxpayer" (Pet. App. 3a).

REASONS FOR DENYING THE WRIT

Petitioner and respondent agree that progressive slot machine jackpots are ordinary and necessary expenses in carrying on the trade or business of gaming and are deductible under Code Section 162. The present case involves the straightforward application of the well established "all events" test which was first formulated by the Supreme Court in *United States v. Anderson,* 269 U.S. 422 (1926), and subsequently adopted by Treasury Regulation § 1.461-1(a)(2). Petitioner and respondent do not disagree with respect to the legal concept governing this case. However, the parties do disagree over the issue of whether the operative facts which establish the existence of a liability have occurred. The disagreement over these facts, however, raises no "special and important reasons" for granting certiorari as required by Supreme Court Rule 17.

The obligation for accrued jackpots is a fixed liability and the winning pull of the handle of the progressive slot machine determines solely the time of payment of the liability and the identity of the payee. All events necessary to the determination of the fact of liability and the amount of such liability occur when the progressive slot machine is placed on the casino floor and the amount of the jackpot liability is reflected on the indicator and thereafter as the amount of the jackpot obligation increases with additional play. Until a guaranteed jackpot is paid, its guaranteed amount may only increase. An increase in a guaranteed jackpot is an event subsequent to the establishment of the respondent's liability for the initial amount shown on the meter and merely increases the amount of an existing liability.

The operative facts giving rise to the liability have already occurred at the time of accrual. The obligation for progressive slot machine jackpots is established by the Nevada Gaming Regulations, statutes, and the policies of the Nevada Gaming Commission ("Commission") and the Nevada Gaming Control Board ("Board") which are binding upon all licensed gaming establishments in the State of Nevada. Under Nevada law, the Commission regulates the activities of licensed gaming establishments in the State of Nevada, and the Board has the authority to enforce the Regulations of the Commission. Prior to September 1972, there were no Gaming Regulations pertaining to progressive slot machines. The progressive slot machine jackpots were not a fixed liability before this time because a licensee could avoid any liability by simply removing the machine from the casino floor. However, in September 1972, the Commission promulgated Regulation § 5.110 which regulates progressive slot machines and, upon the adoption of the Regulation, the liability became fixed. Regulation § 5.110 was effective for all times relevant to the taxable years in issue in this case.

Regulation § 5.110 precludes a licensed gaming establishment from avoiding payment of the liability for accrued but unpaid progressive slot machine jackpots. Under the Regulation, the amount of the liability may not be reduced until the jackpot is paid, and the machine may not be removed from the floor (except for brief repairs) without either paying the accrued jackpot or transferring the obligation for the accrued jackpot to another progressive slot machine which remains in operation.

The Board and the Commission have strictly applied the provisions of Regulation § 5.110 as making guar-

anteed jackpots fixed liabilities of the licensee. The Board requires the licensed gaming establishment to be responsible for the obligation shown on the meter and holds it accountable until the amount is actually paid (C.A. App. 126-27). Further, the policy of the Board and the Commission is, and during the taxable years at issue was, that upon any sale or other disposition of the entire gaming establishment, the liability for accrued jackpots either must be paid to customers prior to the sale of the casino or assumed by the buyer following the sale (C.A. App. 110-11, 130).

A customer of a licensed gaming establishment has administrative remedies available to force the gaming establishment to pay a gaming debt including progressive slot machine jackpots. If a gaming establishment refused to pay a gaming debt to a customer who had properly won the game, N.R.S. § 463.310.4 authorizes the Commission to impose severe sanctions, including fines and the suspension or revocation of the gaming license. As a result of the foregoing Nevada Gaming Regulations, statutes, and policies, the accrued but unpaid progressive slot machine jackpots are liabilities, and once a progressive slot machine is placed in operation on the casino floor, the progressive jackpot must remain available to the customers of the casino until the jackpot is won.

The average time of payment with respect to respondent's guaranteed jackpots has been about 4.5 months. This determination was made as of September 1, 1976, for the twenty-four 4-reel progressive slot machines then in operation. All but two of these machines were installed prior to 1974 (Pet. App. 6a-7a & n.1). (Ninety-two 3-reel machines were operated by respondent and required a significantly lower number of plays than that of the

4-reel machines resulting in a much faster payoff for these machines.) Moreover, as noted above and as petitioner is well aware from the record in the case below, *all* of the accrued but unpaid jackpots in issue in this case were actually won by and paid to customers of respondent.

Petitioner's entire case is premised on its argument that the guaranteed jackpots represent "amounts to which no one can assert any present claim and which respondent may never have to pay at all" (Pet. 7). Petitioner relies on the contorted analysis of the facts set forth by the Ninth Circuit in *Nightingale v. United States*, 684 F.2d 611 (1982), in attempting to advance its position.

The Claims Court and the Federal Circuit correctly rejected *Nightingale*. When viewed against the backdrop of cases interpreting the all events test, *Nightingale* is an aberration, is wrongly decided, and is in direct conflict with substantial judicial precedent including other Ninth Circuit authority. First, the *Nightingale* court stated that "[i]f the [casino] . . . were to close its doors and go out of business, . . . it would not owe the jackpots to anybody. This tends to show that there is no present liability" (684 F.2d at 615). The Ninth Circuit in *Nightingale* also hypothesized that the amount shown on any particular slot machine might never be won because of the inability of any patron to hit the winning combination (684 F.2d at 614).

Petitioner cannot specify a single practical way in which respondent can avoid its liability for guaranteed jackpots. Instead, petitioner focuses on the extremely remote contingencies recited above. These speculative possibilities must be disregarded for federal income tax

purposes because they are not the kind of realistic contingencies that abort satisfaction of the all events test. *Lawyer's Title Guaranty Fund v. United States,* 508 F.2d 1 (5th Cir. 1975). The court in *Zwicker Knitting Mills v. United States,* 80-2 U.S.T.C. ¶ 9832 (Ct. Cl. 1980), stated (80-2 U.S.T.C. at 85,747):

> There is considerable support for the proposition that once a liability is properly accrued, the possibility of a subsequent, unexpected event changing its absolute character or discharging payment entirely should not alter its treatment as a fixed liability during the years accrued.

In *Mooney Aircraft, Inc. v. United States,* 420 F.2d 400 (5th Cir. 1969), Mooney issued to purchasers of its airplanes "Mooney Bonds" which obligated Mooney to pay the bondholder $1,000 upon the retirement of the airplane. The Commissioner contended that the taxpayer could not deduct the bonds in the year of issuance because the obligation they represented was contingent upon the happening of a future event—retirement of the airplane—and therefore the all events test was not met. In holding that the all events test had been satisfied, the court stated at 406:

> To be sure, technically, the liability is "created" by the event of the retirement of a particular plane; if a plane lasted forever there would be no liability. But taxation has been called a "practical field", and we do not see how the technical position the Government takes is designed to further the purpose of the statute . . . [T]here is no doubt at all that the liability will occur since airplanes . . . must cease to function.

Although payment of the liability in the *Mooney* situation depended upon a future event, it did not depend

upon a future contingent event because retirement of the planes was certain. There was no contingency as to the fact of the liability itself; the only contingency related to when the liability would be paid. Thus Mooney's liability was reasonably certain in fact and satisfied the all events test, even though the court believed the event of retirement might not occur for 20 or 30 years for each plane. (However, the court did uphold the disallowance on the basis that it was an exercise of the Commissioner's power under Code § 446(b) to disallow any accounting method not clearly reflecting income. Petitioner does not contend in the present case that respondent's accounting method does not clearly reflect income.)

A certain quantum of reasonableness is implicit in the application of the all events test. Treasury Regulation § 1.461-1(a)(2) does not require that respondent prove the *impossibility* of the occurrence of such subsequent events that might extinguish or reduce the amount of an existing liability. Such a requirement would indeed be anomalous. Obviously, any time an accrual basis taxpayer incurs a liability to make payments in the future, the actual payment will be subject to the contingency of ceasing to do business. Petitioner's contention that such a contingency is sufficient to prevent the accrual of expenses effectively prohibits any business establishment from utilizing the accrual method which is expressly permitted by Code § 446(c)(2) because any business can cease its operations.

Further, the concerns expressed by the Ninth Circuit in *Nightingale* and urged by petitioner here misstate the consequences. Under the tax benefit rule, even if one of the remote possibilities cited by petitioner were ever to materialize, the resulting discharge of the liability for

the guaranteed jackpots would result in income recognition by respondent in an amount equal to the amount of the accrued liability discharged. *See* Code § 61(a); *Hillsboro National Bank v. Commissioner*, 457 U.S. 1103 (1983). Therefore, no windfall expense deduction will be possible for an accrual basis taxpayer. The fact that respondent would be required to recognize the accrued liability as income if the remote possibility of avoiding payment ever materialized was an important consideration in the decision of the Claims Court (Pet. App. 15a).

In *Nightingale*, the Ninth Circuit failed to even cite its decision in *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387 (9th Cir. 1982), *cert. denied*, 459 U.S. 1036 (1982). In *Flamingo Resort*, the Ninth Circuit held that an accrual basis Nevada casino must accrue as income the gaming "markers" representing customers' accounts receivable for which there exists a "reasonable expectancy" of collection. The Ninth Circuit stated that "[t]he debts which the markers' represent are, therefore, fixed; there is a reasonable expectancy of collection; and no contention has been made that the amounts cannot be determined with reasonable accuracy" (*id.* at 1390). The gaming markers in *Flamingo Resort* were not legally enforceable obligations in the State of Nevada or in any other state. Neither the two parties involved in the marker transaction nor any governmental authority could enforce the obligation represented by the markers.

The case for accrual in the present situation is far more compelling in *Flamingo Resort* because the guaranteed jackpot liability is enforceable in Nevada by the Board and Commission. In the present case, the facts establish that an accrued liability exists, and the exact amount of the liability is shown on the jackpot indicator.

Applying the Ninth Circuit's test and the Commissioner's position in *Flamingo Resort* to the present case results in a conclusion that the unpaid progressive slot jackpots can be accrued and deducted. This is so because here, as in *Flamingo Resort*, the accrued but unpaid progressive slot machine jackpot liability is fixed; there is a reasonable expectancy of payment; and no contention has been made that the amount cannot be determined with reasonable accuracy.

The practical effect of petitioner's position in the present case, in view of *Flamingo Resort*, would be to require respondent, an accrual method taxpayer engaged in the gaming business, to report gaming expenses on the cash method while reporting gaming income on the accrual method. Therefore, a gaming taxpayer would have to accrue as income any item for which there exists a "reasonable expectancy" of payment; however, an expense item with the same "reasonable expectancy" would be deducted only when payment is actually made. Such a hybrid accounting method would be inconsistent with Code §§ 451 and 461 and would distort respondent's taxable income. Because the legal tests for the accrual of items of income and expense are identical (Treas. Reg. §§ 1.451-1(a), 1.461-1(a)(2)), and because the Ninth Circuit in *Nightingale* failed to follow (or even discuss) its rationale in *Flamingo Resort*, an irreconcilable conflict exists between the Ninth Circuit's decision in *Nightingale* and its decision in *Flamingo Resort*.

In addition, *Nightingale* ignored well-settled case law which holds that the uncertainty of the time for payment or the identity of the payee of a liability will not prevent its accrual for federal income tax purposes. The Ninth Circuit in *Nightingale* held, "[n]o one can say who will hit

the jackpot on that machine, how much it will be when he hits it, or when he will hit it. There are just too many contingencies to permit accrual of the liability as the taxpayer would have us do." 684 F.2d at 614. In situations like the guaranteed jackpots where only the time of payment and the identity of the payee are uncertain, it is the certainty of the liability which is of utmost importance in applying the all events test. *Lukens Steel Co. v. Commissioner,* 442 F.2d 1131 (3d Cir. 1971), *aff'g* 52 T.C. 764 (1969); *Cyclops Corp. v. United States,* 408 F. Supp. 1287 (W.D. Pa. 1976); *Inland Steel Co. v. United States,* 76-2 U.S.T.C. ¶ 9791 (Ct. Cl. 1976). The existence of the liability precedes the actual winning of a guaranteed jackpot, the event which merely fixes the time of payment of the liability and the identity of the payee. "The crucial point is the legal liability to pay someone at some point in time." *Reynolds Metals Co. v. Commissioner,* 68 T.C. 943, 960 (1977).

In *Washington Post Co. v. United States,* 405 F.2d 1279 (Ct. Cl. 1969), the taxpayer accrued amounts on its books for obligations to a profit incentive plan covering all of its circulation dealers. Under the vesting schedule of the plan, there existed a remote possibility that no participant would become 100 percent vested. The Commissioner argued that there was not a liability because the accrual might never actually be paid. In the alternative, the Commissioner contended that if there were a liability, the liability was not definite enough to be "fixed" under the all events test because the ultimate recipients and the time of actual payment could not be ascertained in the year of accrual. The court found that the taxpayer had irrevocably committed itself to payment of the accrued amounts and held that the "indeterminancy involved does not make the liability any less real, or any

less fixed" (*id.* at 1283). The court further held that certainty of the time of payment and knowledge of the identity of the payee are not prerequisites to accruability (*id.* at 1284). Accordingly, the all events test was satisfied and the taxpayer was entitled to the deduction.

Similarly, respondent also has irrevocably committed to pay the accrued liability for the progressive slot machine jackpots. The liability cannot be avoided. Even the extremely remote possibility which existed in *Washington Post* that no participant would be 100 percent vested does not exist here. The only unknown facts in the present case are the time of payment of the jackpot and the identity of the winning customer.

Another issue addressed by the Ninth Circuit in *Nightingale* was its concern that the casino was deducting an expense that was not being matched in the current taxable year with the income of a winning customer. The Ninth Circuit stated that "[a]nother factor of some significance is that the jackpots will not be taxable as income to any person until they are won." 684 F.2d at 615. No principle of federal income tax law states that a taxpayer may not deduct an accrued expense until a corresponding amount of income is recognized by another taxpayer. In fact, the recognition of the cash and accrual methods of accounting under Code § 446(c) contemplates that there will be timing differences between the recognition of income by one party to a transaction who is on the cash method and the recognition of expense by the other party to the transaction who is on the accrual method. In a transaction between an accrual basis taxpayer and a cash basis taxpayer, the former is obligated to recognize expenses when the all events test is satisfied, while the latter must only report income actually or

constructively received. Matching of income and expense between two different taxpayers is not required. Therefore, it is irrelevant that there is no matching of income and expense between respondent and its customers.

In rendering its opinion, the Ninth Circuit stated that *Nightingale* was "closely in point" with *Brown v. Helvering,* 291 U.S. 193 (1933). Petitioner, citing *Brown,* contends that the accrued but unpaid jackpot liabilities are nothing more than non-deductible reserves. In *Brown,* the taxpayer, an insurance broker, attempted to deduct the estimated amount of commissions which would have to be refunded in the future upon the cancellation of any of the insurance policies which were written by the taxpayer during the taxable year. None of the insurance policies from which the commission income had been derived had been cancelled as of the end of the taxable year at issue, and the taxpayer had no obligation to refund any commissions prior to the cancellation of the policies. The amount which the taxpayer attempted to deduct was merely the amount which he estimated to be refunded in the future. In *Brown,* therefore, there was no pre-existing obligation for refund of insurance premiums. The liability of the insurance company to refund premiums was contingent upon the cancellation of policies by customers. Thus the operative fact giving rise to the disputed liability in the case was the cancellation of each insurance policy, and such operative fact had not yet occurred.

In the present case, the operative facts are the initial placement of the progressive slot machine on the casino floor and each subsequent play of the machine by customers which results in an increase in the liability which cannot be avoided. Pursuant to the Regulations and

statutes, there is a fixed, pre-existing obligation to pay the jackpot because the progressive slot machine jackpots must remain on the casino floor until they are won by customers.

Finally, the Ninth Circuit in *Nightingale* stated that the allowance of the deduction would open the way "for casinos to overcome the restraints of annual accounting in a perfectly legal way. They could put extra machines on the floor on the last day of the tax year with whatever initial jackpot they chose and with whatever odds they liked. Then they could take a current deduction for the full amount even though payment of the jackpots might not occur for many years." 684 F.2d at 615. There was not even a suggestion that such tax avoidance occurred in *Nightingale* and petitioner does not allege that such an abuse has occurred in the present case. Assuming arguendo that there is a basis for such a concern, it is obviated by Code § 446(b) which provides that "[i]f the method used [to compute taxable income] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." The Commissioner's broad discretion and powers under § 446 to modify a taxpayer's accounting method to insure a clear reflection of income have been consistently upheld. *See Commissioner v. Hansen,* 360 U.S. 446, 467 (1959); *Lucas v. American Code Co.,* 280 U.S. 445, 449 (1930). However, where no such practice has been alleged or proven and where the timing of the deduction does not distort income, courts have not acted on mere speculation. Therefore, although no distortion of taxable income resulted in *Nightingale* or in respondent's case, a court could in an appropriate case, disallow a deduction if such abuse were shown to have occurred.

It is the obligation established by Nevada state law that a licensee incurs to the players at the time the licensee places a progressive slot machine in operation that fixes the fact of the licensee's liability within the meaning of Treasury Regulation § 1.461-1(a)(2). The law is well established that a deductible liability can arise from a state legal requirement, and petitioner has not contended otherwise. For example, *Crescent Wharf & Warehouse Co. v. Commissioner,* 518 F.2d 772 (9th Cir. 1975), involved the accrual of an employer's liability to injured employees under workers' compensation laws. The Commissioner argued that liability was not incurred by the employer until medical attention was given to an injured employee and the employer was obligated to pay for the specific medical treatment. The Ninth Circuit held that the estimated liability of the employer for self-insured workers' compensation benefits which were payable pursuant to California law was deductible so long as the amount could be estimated with reasonable accuracy. The injury and not the payment was the event which established liability whether medical services were rendered or disability occurred at that time or in the future.

The most clearly analogous precedent establishing that for purposes of the all events test the guaranteed jackpot constitutes a liability are those cases dealing with coal strip mining operations. *See Denise Coal Co. v. Commissioner,* 271 F.2d 930 (3d Cir. 1959); *Harrold v. Commissioner,* 192 F.2d 1002 (4th Cir. 1951). *Harrold* and *Denise Coal Company* held that the accrued liabilities of strip mining companies to restore the mined land to its original condition were deductible where the obligations to so restore the land arose from state legal requirements. In those cases, the applicable state laws

required the miner to restore the stripped land to its former condition. The taxpayers claimed deductions for the estimated costs of backfilling excavated lands as they stripped the land of coal even though the backfilling operations were not performed until the following year. The Comissioner denied the deduction contending there was no liability until the taxpayer incurred expenses to rehabilitate the land. As in the present case, the Commissioner urged the narrow view that a liability exists only when there is an obligation to presently pay money to an identifiable obligee. There was, however, no obligation to presently pay money to someone who had performed restoration work on the stripped land because the work had not yet been performed. The taxpayers contended that state law imposed an enforceable obligation to restore the land and the cost of restoration was measurable in dollars. The obligation to perform the restoration was the liability, and the operative event establishing the liability was the stripping of the land by the coal operation.

The accruals were allowed in the strip mining cases because in the taxable years in which the deductions were taken, all the operative facts had occurred resulting in the obligation to restore the stripped land. Similarly, in the present case, the Federal Circuit correctly held that the accrued deductions for progressive slot machine jackpots were allowable because in the taxable years in which the deductions were taken, the operative fact of liability had occurred when the progressive slot machines were operated on the casino floor, resulting in the obligation to pay the guaranteed jackpot at a future date.

Petitioner also conjectures that if the jackpot amounts represent fixed liabilities, there should be creditors en-

titled to claim such amounts (Pet. 8, 11). Because petitioner is unable to identify such purported creditors, it concludes that there is no fixed liability prior to the time a patron actually hits the winning combination (Pet. 11). Petitioner's analysis overlooks the fact that the Commission and the Board offer the opportunity to gaming establishments to operate progressive slot machines on the condition that the licensee agrees to abide by the applicable Gaming Regulations. At the time the licensee accepts the offer by placing progressive slot machines in operation, the gaming establishment becomes irrevocably obligated under the Gaming Regulations to pay the guaranteed jackpot at a future date. Accordingly, the obligees at such time are the gaming customers, and the Commission and the Board act as the representatives of such obligees.

To require the deduction of the progressive jackpot liability to be deferred until the year of actual payment as urged by petitioner, rather than the year in which the liability accrues, could wholly distort, rather than clearly reflect, respondent's taxable income. For example, the accrued liability on a particular machine may have progressed to a certain amount by the time a jackpot is won by a customer, with only a few dollars having been played in the machine and recognized as income in the year of payment but with substantial sums having been played and recognized as income in prior years. To require the jackpot to be deducted entirely in the year of payment would distort the taxable income for that year; whereas, the accounting method used by respondent results in the allocation of the expense to the years in which the revenues were earned.

CONCLUSION

Respondent's liability for its guaranteed jackpots satisfies the all events test because the Nevada Gaming Regulations, statutes, and policies impose the liability and because the amount of the liability is readily determinable at any time. In no event can the liability be cancelled by respondent. All events have occurred for proper accrual of the progressive slot machine jackpot liabilities. Accordingly, respondent has properly accrued and deducted the guaranteed jackpot liabilities in the year in which the amounts were registered on the progressive slot machines.

The Federal Circuit in this case and the Ninth Circuit in *Nightingale* purported to apply the same applicable tax law. However, the facts necessary to satisfy the all events test were determined differently by each court. For the reasons discussed above, respondent believes *Nightingale* is poorly reasoned and wrongly decided. The different conclusions reached by these courts concerning the operative facts do not, in any event, warrant review by this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX

Section 1.446-1(c)(1)(ii) of the Treasury Regulations on Income Tax (26 C.F.R.) provides in pertinent part:

> (ii) *Accrual Method.* . . . Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. . . .

Section 463.310 of the Nevada Revised Statutes provides in pertinent part:

> 1. The [Gaming Control Board] shall make appropriate investigations:
>
> (a) To determine whether there has been any violation of this chapter, chapter 464 or chapter 465 of NRS or any regulations adopted thereunder.
>
> (b) To determine any facts, conditions, practices or matters which it may deem necessary or proper to aid in the enforcement of any such law or rules and regulations.
>
> (c) To aid in adopting regulations.
>
> (d) To secure information as a basis for recommending legislation relating to this chapter, chapter 464 or chapter 465 of NRS.
>
> (e) As directed by the commission.

2. If, after any investigation the board is satisfied that a license, registration, finding of suitability, pari-mutuel license or prior approval by the commission of any transaction for which such approval was required or permitted under the provisions of this chapter or chapter 464 of NRS should be limited, conditioned, suspended or revoked, it shall initiate a hearing before the commission by filing a complaint with the commission in accordance with NRS 463.312 and transmit therewith a summary of evidence in its possession bearing on the matter and the transcript of testimony at any investigative hearing conducted by or on behalf of the board.

3. Upon receipt of the complaint of the board, the commission shall review it and all matter presented in support thereof, and, if satisfied that probable grounds exist for disciplinary or other action, shall conduct further proceedings in accordance with NRS 463.312. If the commission is not satisfied that probable grounds exist for disciplinary or other action, it may order the complaint withdrawn without prejudice to the filing of another complaint after further investigation and reconsideration by the board.

4. After the provisions of subsections 1, 2 and 3 above have been complied with, the commission may:

(a) Limit, condition, suspend, or revoke the license of any licensed gaming establishment or the individual license of any licensee without affecting the license of the establishment;

(b) Limit, condition, suspend or revoke any registration, finding of suitability, pari-mutuel license, or prior approval given or granted to any applicant by the commission;

(c) Order a licensed gaming establishment to keep an individual licensee from the premises of such licensed gaming establishment or not to pay such licensee any remuneration for services or any profits, income or accruals on his investment in such licensed gaming establishment; and

(d) Fine the licensee, registrant, person or entity previously found suitable, pari-mutuel licensee, or person or entity who previously obtained approval for any act or transaction for which commission approval was required or permitted under the provisions of this chapter or chapter 464 of NRS, not more than $100,000 for the first violation and not more than $250,000 for each subsequent violation of the provisions of this chapter, chapter 464 or chapter 465 of NRS or of the regulations of the commission. All fines shall be paid to the state treasurer for deposit in the general fund.

. . . .

Section 5.110 of the Nevada Gaming Regulations, as adopted in September 1972, provides:

1. This paragraph shall apply to any slot machine with a payoff indicator which has a payoff that increases as the machine is played.

2. No payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player, or unless the change in the indicator reading is necessitated through a machine malfunction, in which case an explanation must be entered on the daily report as required in subsection 5.

3. If the payoff indicator progresses without a payoff until the indicators return to zero, some means must be utilized to add another digit, unless a dollar limit has been posted on the machine clearly visible to the player, and which was posted before any

payoff was registered on the indicator. When the limit has been reached it must be permitted to remain until won by a player.

4. Once a payoff amount appears on an indicator, the rate of progression may not be changed until there has been a winner, and the indicator is returned to zero.

5. Records shall be maintained which record the amount of the indicated payoff at least once per day. Supporting documents shall be maintained to explain any reduction in the payoff amount from the previous entry. Such records and documents shall be retained for a period of three years unless permission to destroy them earlier is given by the board in writing.

Section 5.110 of the Nevada Gaming Regulations, as amended March 1, 1977, provides:

1. *Applicability.* This regulation shall apply to any slot machine with a payoff indicator which has a payoff that increases as the machine is played.

2. *Limits.* A licensee may impose a limit on the jackpot of a progressive slot machine so long as the limit imposed is greater than the possible maximum jackpot payout showing on the machine at the time the limit is imposed. Progressive slot machines upon which a limit has been imposed by the licensee must have a sign posted predominately upon it informing the public of the limit imposed.

3. *Cash requirements.* Licensees who operates under a restricted license or who are classified as a Grop II nonrestricted licensee must maintain a minimum cash reserve equal to the total of all progressive slot machine jackpots which may be won at the location. Nonrestricted Group I gaming licensees shall at all times maintain sufficient cash or cash

equivalents to provide payment of all progressive jackpots offered to the public as prizes.

4. *Payoff indicators.* No payoff indicator shall be turned back to a lesser amount unless one of the following circumstances occur:

(a) The amount shown on the progressive meter is paid to a player as a jackpot; or

(b) It becomes necessary to adjust the progressive meter to prevent the jackpot indicator from displaying an amount greater than the limit imposed by the licensee pursuant to paragraph 2 of this regulation; or

(c) It becomes necessary to change the jackpot indicator because of machine malfunction, in which case an explanation must be entered on the daily report as required by paragraph 6 of this regulation.

5. *Payoff required.* Once a payoff amount appears on a jackpot indicator, the progressive meter may not be decreased except as allowed by this regulation. A progressive jackpot may be transferred to another progressive machine at the same location in the event of machine malfunction, replacement, or for other good reason. When the maximum jackpot limit is reached, it must be permitted to remain until won by a player.

6. *Records.* Records shall be maintained which record the amount shown on each progressive jackpot meter at least one time daily. Supporting documents shall be maintained to explain any reduction in the payoff amount from the previous entry. Such records and documents shall be retained for a period of five years unless permission to destroy them earlier is given by the board in writing.

7. *Effective date.* This regulation shall become effective on March 1, 1977, and shall apply to all licensees affected thereby who are then or thereafter licensed.

Supreme Court, U.S.
FILED
NOV 14 1985
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-554

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY MEMORANDUM FOR THE UNITED STATES

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

BEST AVAILABLE COPY

TABEL OF AUTHORITIES

Page

Cases:

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In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-554

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY MEMORANDUM FOR THE UNITED STATES

---

1. Respondent concedes (Br. in Opp. 9, 21) that the circuits are squarely in conflict on the question presented. Respondent appears to agree with our contention (Pet. 15-16) that this question is an extremely important one for the gaming industry, involving something like $70 million in tax revenues for that industry alone. And respondent does not dispute our contention (Pet. 16) that the decision below, rendered by a court of nationwide jurisdiction, may have an even greater impact outside the gambling business, permitting taxpayers to claim current tax deductions for all sorts of contingent future losses. Indeed, respondent defends the decision below by citing cases involving accruals of deductions for such diverse items as workmen's compensation claims, payments to profit-sharing plans, duties under service contracts, and obligations to restore strip-mined land (Br. in Opp. 10, 14, 18-19). In short, respondent has said nothing to contradict our submission that the

circuits are in conflict on an important question meriting this Court's review.

2. Respondent devotes almost its entire brief (Br. in Opp. 6-20) to an elaboration of its contention that the decision below is correct and that the Ninth Circuit's conflicting decision in *Nightingale* v. *United States*, 684 F.2d 611 (1982), was "wrongly decided" (Br. in Opp. 9, 21). We think that this contention can best be debated in briefs on the merits. A few points, however, warrant a short reply now:

a. Respondent characterizes our argument as permitting the deduction of progressive jackpot liabilities only upon their "actual payment," and asserts that the effect of our position is irrationally to place it, an accrual-method taxpayer, on the cash method of accounting for such deductions (Br. in Opp. 5, 13). This characterization is incorrect. Our position is that respondent cannot accrue a deduction for its progressive jackpots until somebody actually wins them. The event that converts respondent's offer of a jackpot into a fixed liability, and which is thus a sine qua non of deductibility under the "all events" test, is the winning pull of the slot machine handle. Once that event has occurred, respondent may properly accrue a deduction regardless whether it writes the gambler a check for his winnings at once, or defers payment until the next day or the next year. Except in the situation (probably rare) where the casino contests its liability to the winning customer, the time and mode of actual payment are irrelevant.

b. Respondent reiterates its contention that its liability to pay a progressive jackpot becomes "fixed" the moment a machine is placed on the floor, and asserts that the IRS seeks improperly to deny it a deduction because of such "remote possibilities" as its becoming bankrupt or ceasing to do business (Br. in Opp. 6, 11). This argument again misstates our position. What prevents respondent from

accruing a deduction is not the possibility that it might avoid paying the jackpots by entering bankruptcy, but rather is the fact that the jackpots have not yet been *won* by anyone. The winning handle pull, in our view, is a "condition precedent" to the creation of a fixed liability. Remote contingencies like bankruptcy, which might serve to divest respondent of its obligation on liabilities once they have become fixed, are properly regarded as "conditions subsequent." It is well settled that conditions of the latter sort do not preclude accruals under the "all events" test, and we are not contending otherwise. We mentioned the bankruptcy scenario (Pet. 10-11) merely as a way of illustrating, in a graphic way, that respondent has no present liability at all. The point is not that respondent has creditors whose *claims might be discharged* in bankruptcy. The point is that no slot machine player could even *assert a claim* against respondent in bankruptcy unless and until he had won a jackpot.

c. Respondent notes correctly that this case concerns the proper timing of deductions, not the intrinsic propriety of the deductions themselves, and that, if it were permitted to accrue deductions for jackpots that nobody ever wins, it would have to recognize a corresponding amount of income in some later tax year (Br. in Opp. 4, 11-12). But to suggest, as respondent seems to do, that these considerations diminish the significance of the issue is to ignore the time value of money. A deduction today is worth more than a deduction one, five, or twenty years from now; if the accruals involved are sufficiently large, their time value alone, as this case demonstrates (Pet. 5, 15-16), can involve huge amounts of revenue. Disputes about the "all events" test *necessarily* concern the proper time for accruing income and deductions. It is precisely because large sums hinge on the outcome that "all events" questions are so frequently and so fervently litigated.

d. Finally, respondent contends that "[t]he Federal Circuit in this case and the Ninth Circuit in *Nightingale* purported to apply the same applicable tax law," and asserts that the two cases thus involve a mere "disagreement over [the] facts" unworthy of further review (Br. in Opp. 6, 21). It is of course true that both circuits began with the same theoretical formulation of the "all events" test, which, in its general terms, has remained unchanged since it was enunicated by this Court sixty years ago. *United States* v. *Anderson*, 269 U.S. 422 (1926). The question here, as in most "all events" cases, concerns not the formulation of the test, but its application to a particular species of facts — the determination, in other words, of which events are the relevant and dispositive events for federal tax purposes. Everyone agrees that the facts of *Nightingale* and the facts of this case, which were stipulated, are substantially identical. Since two courts of appeals have reached contradictory results purporting to apply the same test to the same facts, it is obvious that one of those courts has misapprehended the governing legal standard. That error is an error of law, and starkly indicates that further clarification of that standard by this Court is needed in this much litigated area of tax law.

For these reasons and for the reasons set forth in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED
Solicitor General

NOVEMBER 1985

DOJ-1985-11

Supreme Court, U.S.
FILED
JAN 30 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-554

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

JOINT APPENDIX

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Counsel for Petitioner

PETITION FOR A WRIT OF CERTIORARI FILED SEPTEMBER 30, 1985
CERTIORARI GRANTED DECEMBER 2, 1985

81PM

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* The opinions and judgments of the court of appeals and of the district court are printed in the appendix to the petition for writ of certiorari and have not been reproduced here.

IN THE UNITED STATES CLAIMS COURT

No. 594-82T

HUGHES PROPERTIES, INC.

v.

THE UNITED STATES

RELEVANT DOCKET ENTRIES

DATE	PROCEEDINGS
Nov 19 1982	Filing fee of $60 paid by plaintiff.
Nov 19 1982	Notice of assignment to Judge Robert M. M. Seto filed. Notice to parties.
Jan 14 1983	Defendant's motion for enlargement of time (to MAR 4 1983) to answer etc. the complaint filed. Service by mail: JAN 14 1983. ALLOWED:
Mar 1 1983	Defendant's answer filed. Service by mail: 3/1/83.
Mar 10 1983	Judge's standard pretrial order on liability (Rule 16) filed. Copy to parties. [Submission: May 10, 1983]
Jun 8 1983	Defendant's motion for enlargement of time (to July 8 1983) to respc to the pretrial order on liability filed. Service by mail: 6/8/83. ALLOWED: JUN 10 1983.
Jul 8 1983	Defendant's motion for extension of time (to July 29, 1983) to comply with pretrial order filed. Service by mail: 7/8/83. ALLOWED: AUG 9

DATE	PROCEEDINGS
Jul 29 1983	Defendant's motion for summary judgment filed. Service by mail: 7/29/83.
Jul 29 1983	Defendant's motion for suspension of pretrial proceedings (pending decision on motion for summary judgment) filed. Service by mail: 7/29/83. ALLOWED: SEP 20 1983.
Aug 29 1983	Plaintiff's cross-motion for summary judgment and opposition to defendant's motion for summary judgment filed. Service by mail: 8/26/83.
Sep 26 1983	Defendant's reply brief in support of its motion for summary judgment and in opposition to plaintiff's cross-motion for summary judgment for Service by mail: 9/26/83.
Oct 12 1983	Plaintiff's reply brief filed. Service by mail: 10/11/83.
Oct 28 1983	Judge's order scheduling oral arguments filed. Copy to parties.
Nov 23 1983	Order entered vacating order scheduling oral arguments filed October Copy to parties.
Feb 3 1984	Judge's order scheduling oral argument, and directing counsel to pre motions or additional matters by informing the court by February 10, 1984, filed. Copy to parties.
Feb 22 1984	Transcript of proceedings (1 volume) taken at Washington, D.C. on February 16, 1984 filed. Notice to parties.
Jun 29 1984	Judge's opinion dismissing defendant's motion for summary judgment and granting plaintiff's motion for summary judgment filed. Parties are to submit joint stipulation: JUL 30 1984. Upon receipt the Clerk shall enter judgment for plaintiff. Copy to parties.

DATE	PROCEEDINGS
Jul 30 1984	Stipulation of the parties filed by deft. Service by mail: 7/30/84.
Aug 1 1984	Judgment entered that plaintff recover the amounts as listed below, plus statutory interest:

Taxable Year Ending	Tax Refund Due
June 30, 1973	$172,909.70
June 30, 1974	97,802.61
June 30, 1975	139,008.11
June 30, 1977	23,721.46

Copy to parties.

Aug 1 1984	Certified transcript of judgment forwarded to attorney of record. See correspondence in file.
Sep 28 1984	Defendant's notice of appeal filed. Copy to plaintiff and C.A.F.C.

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 85-503
594-82T

HUGHES PROPERTIES, INC., PLAINTIFF-APPELLEE

v.

THE UNITED STATES, DEFENDANT-APPELLANT

RELEVANT DOCKET ENTRIES

DATE		PROCEEDINGS
		COUNSEL FOR THE APPELLANT: Mary L. Fahey
		COUNSEL FOR THE APPELLEE: Denton N. Thomas, O.C. Lilienstern 11/30
October 9, 1984	1.	Certificate of Interest filed by appellee. (bam)
November 28, 1984	2.	Motion of appellant to extend time for filing brief/appendix to and including Jan. 3, 1985, filed. (dm) (SD 11/27 M) GRANTED: November 30, 1984. (NO FURTHER EXTENSIONS SHOULD BE EXPECTED.) (ejc)
January 3, 1985		BRIEF/SEPARATE APPENDIX VOLS. I & II FOR APPELLANT, filed. (SD-1/3-M)
February 8, 1985		BRIEF FOR THE APPELLEE, filed. (SD-2/8-M) scg

DATE	PROCEEDINGS
February 26, 1985	REPLY BRIEF FOR APPELLANT, filed. (SD-2/25-M) scg
March 1, 1985	Letter to counsel re NEw Orleans argument on 3/28/85.
March 28, 1985	Argued (New Orleans). Bennett, Smith & Bissell, JJ
May 2, 1985	JUDGMENT AFFIRMED. OPINION BY BENNETT, CIRCUIT JUDGE
May 15, 1985	Appellee's Bill of Costs, filed ALLOWED: 6/19/85 for $88.00.
June 18, 1985	MANDATE ISSUED TO U.S. CLAIMS COURT. (dm)
September 30, 1985	PETITION FOR CERTIORARI FILED IN THE SUPREME COURT. (85-554)

IN THE UNITED STATES CLAIMS COURT

File No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

COMPLAINT

(Filed November 19, 1982)

TO THE HONORABLE JUDGES OF THE UNITED STATES CLAIMS COURT:

Plaintiff, Hughes Properties, Inc. (formerly Hughes Television Network, Inc. and Sands, Inc.), files this complaint to recover from the United States of America overpayments of Federal income taxes and interest for the fiscal years ended June 30, 1973, 1974, 1975, and 1977, and for its cause of action states as follows:

1. This Court has jurisdiction over this action by virtue of Title 28, U.S.C. Sections 1346 and 1491. Plaintiff's cause of action arises under Title 26, U.S.C. (Internal Revenue Code of 1954, as amended) Section 446.

2. Plaintiff is a Nevada corporation with principal executive offices at 4045 South Spencer Street, Las Vegas, Nevada 89109.

3. (a) Plaintiff seeks to recover from defendant the amount of $239,470.00 or such greater amount as may be legally due, with interest thereon according to law, representing overpayments of Federal income taxes in the

amount of $172,909.00, and interest collected thereon in the amount of $66,561.00, erroneously assessed and collected by the Internal Revenue Service for the fiscal year ending June 30, 1973.

(b) Plaintiff seeks to recover from defendant the amount of $129,638.00 or such greater amount as may be legally due, with interest thereon according to law, representing overpayments of Federal income taxes in the amount of $97,844.00, and interest collected thereon in the amount of $31,794.00, erroneously assessed and collected by the Internal Revenue Service for the fiscal year ending June 30, 1974.

(c) Plaintiff seeks to recover from defendant the amount of $175,049.00 or such greater amount as may be legally due, with interest thereon according to law, representing overpayments of Federal income taxes in the amount of $139,008.00, and interest collected thereon in the amount of $36,041.00, erroneously assessed and collected by the Internal Revenue Service for the fiscal year ending June 30, 1975.

(d) Plaintiff seeks to recover from defendant the amount of $28,661.00 or such greater amount as may be legally due, with interest thereon according to law, representing overpayments of Federal income tax in the amount of $23,721.00, and interest collected thereon in the amount of $4,940.00, erroneously assessed and collected by the Internal Revenue Service for the fiscal year ending June 30, 1977.

4. The said overpayments result from an erroneous determination by the Internal Revenue Service that for the purpose of Federal income taxes Plaintiff could not deduct currently accrued progressive slot machine jackpot payoffs on the grounds that Plaintiff's liability is contingent until a jackpot is actually paid, and until such payment the amount of the liability cannot be determined with reasonable accuracy. In fact, all of the events have occurred which determine that the Plaintiff has incurred a liability, the liability of Plaintiff for jackpots on pro-

gressive slot machines is not contingent upon the occurrence of a future event—the actual winning of the guaranteed jackpot, the liability incurred is measurable in money with reasonable accuracy in the tax year in which it is accrued, and thus such amounts are deductible expenses in the year accrued.

5. (a) For the fiscal year ending June 30, 1973, Plaintiff (then Sands, Inc. and Subsidiaries, 88-0062602, 25th Floor, Exxon Building, Houston, Texas) filed its Federal income tax return on or about December 7, 1973, in Austin, Texas.

(b) For the fiscal year ending June 30, 1974, Plaintiff (then Sands, Inc. and Subsidiaries, 88-0062602, 25th Floor, Exxon Building, Houston, Texas) filed its Federal income tax return on or about March 13, 1975, in Austin, Texas.

(c) For the fiscal year ending June 30, 1975, Plaintiff (then Hughes Television Network, Inc. [formerly Sands, Inc.], 88-0062602, 25th Floor, Exxon Building, Houston, Texas) filed its Federal income tax return on or about March 15, 1976, in Austin, Texas.

(d) For the fiscal year ending June 30, 1977, Plaintiff (Hughes Properties, Inc., 88-0062602, P. O. Box 14000, Las Vegas, Nevada) filed its Federal income tax return on or about March 10, 1978, in Ogden, Utah.

6. (a) For the fiscal year ending June 30, 1973, Plaintiff paid to the Internal Revenue Service Federal income taxes in the amount of $1,557,095.00.

(b) For the fiscal year ending June 30, 1974, Plaintiff paid to the Internal Revenue Service Federal income taxes in the amount of $2,196,288.00.

(c) For the fiscal year ending June 30, 1975, Plaintiff paid to the Internal Revenue Service Federal income taxes in the amount of $1,530,621.00.

(d) For the fiscal year ending June 30, 1977, Plaintiff paid to the Internal Revenue Service Federal income taxes in the amount of $2,768,677.00.

7. (a) With respect to the payment of part of the taxes described in paragraph 6(a), the Internal Revenue Service assessed against Plaintiff Federal income tax in the amount of $172,909.00, plus interest thereon in the amount of $66,561.00, based on the determination by the Internal Revenue Service that Plaintiff could not deduct currently the guaranteed jackpot on progressive slot machines for the fiscal year ending June 30, 1973.

(b) With respect to the payment of part of the taxes described in paragraph 6(b), the Internal Revenue Service assessed against Plaintiff Federal income tax in the amount of $97,844.00, plus interest thereon in the amount of $31,794.00, based on the determination by the Internal Revenue Service that Plaintiff could not deduct currently the guaranteed jackpot on progressive slot machines for the fiscal year ending June 30, 1974.

(c) With respect to the payment of part of the taxes described in paragraph 6(c), the Internal Revenue Service assessed against Plaintiff Federal income tax in the amount of $139,008.00. plus interest thereon in the amount of $36,041.00, based on the determination by the Internal Revenue Service that Plaintiff could not deduct currently the guaranteed jackpot on progressive slot machines for the fiscal year ending June 30, 1975.

(d) With respect to the payment of part of the taxes described in paragraph 6(d), the Internal Revenue Service assessed against Plaintiff Federal income tax in the amount of $23,721.00, plus interest thereon in the amount of $4,940.00, based on the determination by the Internal Revenue Service that Plaintiff could not deduct currently the guaranteed jackpot on progressive slot machines for the fiscal year ending June 30, 1977.

8. (a) On June 29, 1979, Plaintiff paid to the Internal Revenue Service, Las Vegas, Nevada, the amount of $239,470.00 in satisfaction of the Federal income tax and interest assessments described in paragraph 7(a).

(b) On June 29, 1979, Plaintiff paid to the Internal Revenue Service, Las Vegas, Nevada, the amount of

$129,638.00 in satisfaction of the Federal income tax and interest assessments described in paragraph 7(b).

(c) On July 13, 1979, Plaintiff paid to the Internal Revenue Service, Las Vegas, Nevada, the amount of $175,049.00 in satisfaction of the Federal income tax and interest assessments described in paragraph 7(c).

(d) On December 10, 1980, Plaintiff paid to the Internal Revenue Service, Las Vegas, Nevada, the amount of $28,661.00 in satisfaction of the Federal income tax and interest assessments described in paragraph 7(d).

9. (a) On or about November 12, 1980, Plaintiff (Hughes Properties, Inc., 4045 South Spencer Street, Las Vegas, Nevada) timely filed with the Internal Revenue Service, Ogden, Utah, a formal claim for refund of $239,470.00, representing Federal income tax paid for the year ending June 30, 1973, in the amount of $172,909.00, and interest paid thereon in the amountof $66,561.00.

Such claim asserted that all of the events had occurred which determined that the Plaintiff had incurred a liability, such liability existed prior to the guaranteed jackpot payoff and was not contingent upon the occurrence of a future event, and the liability incurred was measurable in money with reasonable accuracy in the year in which it was accrued.

(b) On or about November 12, 1980, Plaintiff (Hughes Properties, Inc., 4045 South Spencer Street, Las Vegas, Nevada) timely filed with the Internal Revenue Service, Ogden, Utah, a formal claim for refund of $129,638.00, representing Federal income tax paid for the year ending June 30, 1974, in the amount of $97,844.00, and interest paid thereon in the amount of $31,794.00.

Such claim asserted that all of the events had occurred which determined that the Plaintiff had incurred a liability, such liability existed prior to the guaranteed jackpot payoff and was not contingent upon the occurrence of a future event, and the liability incurred was measurable in money with reasonable accuracy in the year in which it was accrued.

(c) On or about November 12, 1980, Plaintiff (Hughes Properties, Inc., 4045 South Spencer Street, Las Vegas, Nevada) timely filed with the Internal Revenue Service, Ogden, Utah, a formal claim for refund of $175,049.00, representing Federal income tax paid for the year ending June 30, 1975, in the amount of $139,008.00, and interest paid thereon in the amount of $36,041.00.

Such claim asserted that all of the events had occurred which determined that the Plaintiff had incurred a liability, such liability existed prior to the guaranteed jackpot payoff and was not contingent upon the occurrence of a future event, and the liability incurred was measurable in money with reasonable accuracy in the year in which it was accrued.

(d) On or about February 12, 1981, Plaintiff (Hughes Properties, Inc., P. O. Box 14000, Las Vegas, Nevada) timely filed with the Internal Revenue Service, Ogden, Utah, a formal claim for refund of $28,661.00, representing Federal income tax paid for the year ending June 30, 1977, in the amount of $23,721.00, and interest paid thereon in the amount of $4,940.00.

Such claim asserted that all of the events had occurred which determined that the Plaintiff had incurred a liability, such liability existed prior to the guaranteed jackpot payoff and was not contingent upon the occurrence of a future event, and the liability incurred was measurable in money with reasonable accuracy in the year in which it was accrued.

10. On or about April 30, 1981, an officer of Plaintiff, who was authorized to sign, executed and delivered to the Internal Revenue Service a Waiver of Statutory Notification of Claim Disallowance (Form 2297) waiving the requirement under section 6532(a)(1) of the Internal Revenue Code that a notice of claim disallowance be sent to Plaintiff by certified or registered mail for the claims for refund described in paragraphs 9(a), (b) and (c).

11. On or about November 4, 1981, an officer of Plaintiff, who was authorized to sign, executed and delivered

to the Internal Revenue Service a Waiver of Statutory Notification of Claim Disallowance (Form 2297) waiving the requirement under section 6532(a)(1) of the Internal Revenue Code that a notice of claim disallowance be sent to Plaintiff by certified or registered mail for the claim for refund described in paragraph 9(d).

12. No part of the amount herein claimed has ever been paid or credited to Plaintiff. No action on these claims other than that described herein has been taken by Congress or any department or agency of the United States or in any judicial proceeding.

13. Plaintiff is and always has been the sole owner of the claims for refund described herein; it has not assigned or transferred such claims or any part thereof or interest therein.

WHEREFORE, Plaintiff prays for judgment in the amount of $572,818.00, or such greater amount as Plaintiff may be entitled to recover, together with interest thereon according to law, and for such other and further relief, including costs, as to this Court may seem just and proper.

Respectfully submitted,

/s/ Denton N. Thomas
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Attorney for Plaintiff

Of Counsel:

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IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

ANSWER

[Filed Mar. 1, 1983]

Defendant, the United States, in answer to the complaint in the above-captioned case, respectfully denies each and every allegation contained therein not admitted, qualified, or expressly referred to below:

Defendant further:

1. Admits that this Court has jurisdiction over this action and avers that the provisions of the Internal Revenue Code of 1954, as amended, govern the controversy in question in this litigation.

2. Admits the allegations contained in paragraph 2.

3. Admits that plaintiff seeks to recover the amounts specified in paragraphs 3(a) through 3(d), but denies that any of the amounts referred to therein represented overpayments or were erroneously assessed against or collected from plaintiff.

4. Denies the allegations contained in paragraph 4, and specifically denies that the Internal Revenue Service's determination referred to in the first sentence therein was erroneous.

5. Admits that plaintiff's returns referred to in paragraphs 5(a) through 5(d) were timely filed.

6-7. Admits the allegations contained in paragraphs 6 and 7.

8. Admits the allegations contained in paragraphs 8 (a) and 8(b). States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraphs 8(c) and 8(d).

9. Admits that the claims for refund referred to in paragraph 9 were timely filed. Further admits that the said claims contained the assertions referred to in the second full paragraph of each of the paragraphs numbered 9(a) through 9(d), inclusive, but denies that the "all events" test within the meaning of Treasury Regulations Section 1.461-1(a)(2) was satisfied with respect to plaintiff's claimed deduction in controversy in this litigation.

10. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 10.

11. Admits the allegations contained in paragraph 11.

12-13. States that its attorneys presently lack knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraphs 12 and 13.

WHEREFORE, defendant requests that the complaint be dismissed, with all allowable costs assessed against plaintiff.

Respectfully submitted,

/s/ Glenn L. Archer, Jr.
GLENN L. ARCHER, JR.
Assistant Attorney General

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

MOTION OF THE UNITED STATES FOR SUMMARY JUDGMENT

Defendant, the United States, pursuant to Rule 56 of the Rules of this Court, respectfully moves for summary judgment in its favor. There is no genuine issue as to any material fact, and the defendant is entitled to judgment as a matter of law.

In support of this motion, defendant relies on the Affidavit of David C. Hickman and the exhibit thereto,* and our accompanying brief.

WHEREFORE, defendant prays that its motion be granted.

Respectfully submitted,

/s/ Glenn L. Archer, Jr.
GLENN L. ARCHER, JR.
Assistant Attorney General

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* The Affidavit of David C. Hickman and the exhibit thereto are contained in the separately bound Appendix to the brief in support of this motion.

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF DAVID C. HICKMAN

CITY OF WASHINGTON)
) SS
DISTRICT OF COLUMBIA)

I, David C. Hickman, hereby affirm and attest that the following allegations are true to the best of my knowledge and belief:

1. I am the trial attorney assigned by the Department of Justice to the defense of this case.

2. That attached hereto is plaintiff's submission in response to the pretrial issued on February 24, 1983.

Further, affiant sayeth not.

I declare under penalty of perjury that the foregoing is true and correct. Executed on July 29, 1983, in Washington, D.C.

/s/ David C. Hickman
DAVID C. HICKMAN

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

PLAINTIFF'S SUBMISSION IN RESPONSE TO PRETRIAL ORDER

For convenience of reference, the Plaintiff's submission in compliance with the Pretrial Order which was filed March 10, 1983, follows the format of such Order by citing the numbered paragraph pursuant to which each portion of a particular submission has been prepared.

1. *Plaintiff's submission.*

(a) Documents to be relied on and offered in evidence—

Plaintiff's Exhibit Number 1: Audited financial statements of Harolds Club, Inc. for fiscal year ending June 30, 1973

Plaintiff's Exhibit Number 2: Audited financial statements of Harolds Club, Inc. for fiscal year ending June 30, 1974

Plaintiff's Exhibit Number 3: Audited financial statements of Harolds Club, Inc. for fiscal years ending June 30, 1974 and June 30, 1975

Plaintiff's Exhibit Number 4: Audited financial statements of Harolds Club, Inc. for fiscal years ending June 30, 1976, and June 30, 1977

Plaintiff's Exhibit Number 5: Letter dated February 2, 1978, from Mr. A. J. Hicks, Deputy Attorney General, Chief, Gaming Division, State of Nevada, and attachments

Plaintiff's Exhibit Number 6: State of Nevada Gaming Commission Regulation 5.110 (as (adopted in September 1972)

Plaintiff's Exhibit Number 7: State of Nevada Gaming Commission Regulation 5 (as amended effective March 1, 1977)

Plaintiff's Exhibit Number 8: State of Nevada Gaming Commission Regulation 7

Plaintiff's Exhibit Number 9: Nevada Revised Statutes §§ 463.310, 463.312, and 463.315

Plaintiff's Exhibit Number 10: Letter dated August 20, 1976, from Mr. Jeffrey A. Silver, Member of the Gaming Control Board of the State of Nevada

Plaintiff's Exhibit Number 11: Schedule of guaranteed jackpot payouts on Harolds Club's 4-reel progressive slot machines from September 9, 1971 to September 1, 1976

Plaintiff's Exhibit Number 12: Schedule of Harolds Club's progressive slot machines' liabilities as of June 30, 1977, and subsequent guaranteed jackpot payouts

Plaintiff's Exhibit Number 13: A statement of the proposed direct testimony of each prospective expert witness who will be called by Plaintiff at the trial—

(A) Mr. Philip P. Hannifin (formerly Chairman of the Nevada Gaming Control Board):

The amount of the accrued but unpaid progressive slot machine jackpot liability can be determined by reading the payoff indicator on the machine. The payoff indicator states the exact amount of the accrued but unpaid progressive slot machine jackpot for that machine at that particular point in time. Thus the amount of the accrued liability can be determined with reasonable accuracy. The winning pull of the handle of the progressive slot machine determines solely the time of the payment of liability and the identity of the payee.

The Nevada Gaming Regulations are binding upon all licensed gaming establishments in the State of Nevada. On July 1, 1972, there were no regulations pertaining to progressive slot machines. At that time, the amount for each machine was not a fixed liability because the Plaintiff could avoid the liability by removing the machine from the casino floor. Upon the adoption of Gaming Regulation § 5.110 in September of 1972, the liability became fixed. Regulation § 5.110 precludes a licensed gaming establishment from avoiding payment of accrued but unpaid progressive slot machine jackpots. Harolds Club is a licensed gaming establishment subject to the Nevada Gaming Regulations.

(B) Mr. John H. Stratton (formerly a Member of the Nevada Gaming Control Board):

If a licensed gaming establishment proposes to discontinue the use of a progres-

sive slot machine, the policy of the Nevada Gaming Control Board is, and during the taxable years at issue was, to require the gaming establishment to either (a) continue the progressive slot machine in play until the progressive jackpot has been paid to a winning customer or (b) transfer the progressive jackpot amount to another progressive slot machine remaining in play at the licensed gaming establishment.

If a licensed gaming establishment proposes a sale or other disposition of the entire gaming business, the policy of the Nevada Gaming Control Board is, and during the taxable years at issue was, to require the buyer to continue the progressive slot machines in play following the sale or other disposition with the same or greater progressive jackpot amounts as at the time of the sale until the jackpots are won by customers of the buyer. Whether or not the sales price for the gaming business is to be adjusted to reflect the assumption of the progressive slot machine liabilities is to be a subject of contractual negotiations between the buyer and seller. The policy of the Nevada Gaming Control Board is, and as of June 30, 1973-1977, was, to not approve the sale or other disposition unless adequate provision was made for the payment of the progressive slot machine liabilities prior to the sale or the assumption of the liabilities by the buyer following the sale.

(C) Mr. Peter Echeverria (formerly a Member and Chairman of the Nevada Gaming Commission):

If a licensed gaming establishment proposed to discontinue the use of a progres-

sive slot machine, the policy of the Nevada Gaming Commission during the taxable years at issue was to require the gaming establishment to either (a) continue the progressive slot machine in play until the progressive jackpot had been paid to a winning customer or (b) transfer the progressive jackpot amount to another progressive slot machine remaining in play at the licensed gaming establishment.

If a licensed gaming establishment proposed a sale or other disposition of the entire gaming business, the policy of the Nevada Gaming Commission during the taxable years at issue was to require the buyer to continue the progressive slot machines in play following the sale or other disposition with the same or greater progressive jackpot amounts as at the time of the sale until the jackpots were won by customers of the buyer. Whether or not the sales price for the gaming business was to be adjusted to reflect the assumption of the progressive slot machine liabilities was a subject of contractual negotiations between the buyer and seller. The policy of the Nevada Gaming Commission was to not approve the sale or other disposition unless adequate provision was made for the payment of the progressive slot machine liabilities prior to the sale or the assumption of the liabilities by the buyer following the sale.

(D) Mr. Jeffrey A. Silver (formerly a Member of the Nevada Gaming Control Board):

The provisions of Nevada Gaming Commission Regulation § 5.110 have been applied by the Nevada Gaming Control Board as making guaranteed jackpots fixed liabilities of the licensee. Two instances of the Board's application of this fixed liability concept are as follows:

(1) A licensee requested permission to remove a progressive slot machine from operation and replace it with a regular slot machine. The Board granted approval upon the condition that the guaranteed jackpot of the removed progressive slot machine be added to the guaranteed jackpot amount of another progressive slot machine.

(2) A licensee who initially operated as a sole proprietorship but who had subsequently acquired a partner requested permission to remove all progressive slot machines from its casino floor. Even though a new individual had become a licensee and the form of casino ownership had changed to a partnership, the Board denied permission since the guaranteed progressive jackpots had not been paid.

Once a progressive slot machine is placed in operation, the liability for its guaranteed jackpot cannot be avoided by removing the machine, changing the form of the licensee's business operations or by a change of licensees. Sums shown on the meter, in contrast to standard slot machines, actually represent participation by the players, a portion of their play being used to increase the award. The Board in recognizing this investment requires the licensee to be responsible for the obligation shown on

the meter and holds it accountable until the amount is actually paid.

(E) Mr. A. J. Hicks (Formerly Deputy Attorney General, Chief, Nevada Gaming Division)

Pursuant to § 463.310 of the Nevada Revised Statutes, as in effect during the taxable years in issue, administrative remedies could be imposed against any licensed gaming establishment which wrongfully refused to pay a progressive slot machine jackpot which had been won by a customer. The administrative remedies included fines and/or the revocation or suspension of the gaming license.

(F) Mr. Philip D. Griffith:

The total amount of accrued but unpaid progressive slot machine jackpots of Plaintiff at the close of business was as follows:

Fiscal Year Ended June 30	Accrued Liability	Expense (Income)
1973	$360,228.55	$360,228.55
1974	563,983.99	203,755.44
1975	853,584.22	289,600.23
1976	839,400.97	(14,183.25)
1977	888,820.67	49,419.70

In the case of Plaintiff, the payment of the accrued progressive slot machine jackpots cannot be avoided so long as the Plaintiff remains in the gaming business. Under Nevada law, if the Plaintiff were to surrender its gaming license, it would no longer be subject to the gaming laws and regulations and could thus avoid the payment of the liability. However, considering the magnitude of the investment in Harolds Club and the success and financial condition of the Plaintiff as of the end of the taxable years at issue and as of the present time, the possibility of the Plaintiff discontinuing its

gaming operations certainly is extremely remote. The only other circumstance under which the Plaintiff could avoid the payment of the liability would be if the Plaintiff became bankrupt. Once again, however, considering the financial condition of the Plaintiff at the end of the taxable years at issue, such a possibility certainly was extremely remote and speculative.

The facts indicate that all of the accrued but unpaid progressive slot machine jackpots as of June 30, 1977, were subsequently won by and paid to customers of the Plaintiff. The average period of time between Harolds Club's payoffs on a progressive slot machine's guaranteed jackpot is approximately 4.5 months. This determination was made as of September 1, 1976, of the twenty-four (24) 4-reel progressive slot machines then in operation. All but two of these machines were installed prior to 1974. With the exception of two machines, one of which had been in operation thirteen (13) months and the other thirty-five (35) months, that did not pay off prior to September 1, 1976, the payoff frequency ranged from a high of 14.3 months to a low of 1.9 months. As of September 1, 1976, Harolds Club also operated ninety-two (92) 3-reel progressive slot machines. The average number of "plays" required for a payoff on these machines is significantly lower than that of the 4-reel machines. Thus their payoff is much faster than that of the 4-reel machines. Accordingly, the volume of play on the progressive slot machines of Plaintiff, the odds of a customer winning the jackpot, and the fact that all of the accrued progressive jackpots of Plaintiff as of June 30, 1977, have been paid establish that there does

exist a reasonable expectancy of payment of the accrued progressive slot machine jackpots.

(G) Mr. Gene Harris:

In the case of progressive slot machines, the amount of the liability for accrued but unpaid jackpots increases in direct proportion to the number of coins played in the machine. The accrued progressive slot machine liability of Plaintiff is incurred in the year in which the related income is earned from the play on the machine. The reporting of accrued but unpaid progressive slot machine jackpots as accrued liabilities and any increases in the accrued liabilities as a reduction of the slot machine gross profit of the licensed gaming establishment conforms with generally accepted accounting principles, results in a proper matching of revenues and expenses and clearly reflects income. Since all subsequent increases in the amount of the jackpot must result from play on the machines and the corresponding recognition of taxable income by the casino, there would be no distortion of income resulting from the deduction of the subsequent accrual. To require the deduction to be deferred until the year of actual payment, rather than the year in which the liability accrues, could result in a material distortion of the Plaintiff's taxable income for the year of payment. The amount of the related expenses is minimal compared to the amount of income recognized.

(b) Plaintiff hereby alleges the following facts, all of which are material, and none of which is genuinely in issue.

(1) Plaintiff, Hughes Properties, Inc. (formerly Hughes Television Network, Inc. and

Sands, Inc.) is a Nevada corporation which operates a gambling casino in Nevada under the name of Harolds Club. The issue in dispute in this case concerns the taxable income of Plaintiff for the Plaintiff's taxable years ending June 30, 1973, 1974, 1975 and 1977.

(2) Plaintiff filed its Federal income tax returns for the taxable years ending June 30, 1973, 1974, 1975 and 1977 in a timely manner. The Federal income taxes for such taxable years were paid by Plaintiff in a timely manner. Plaintiff claimed a deduction on its Federal income tax returns for the taxable years ending June 30, 1973, 1974, 1975 and 1977 for the liability of Plaintiff for progressive jackpot amounts which were accrued but unpaid as of June 30, 1973, 1974, 1975 and 1977.

(3) The consistency of Plaintiff's application of accrual principles is evidenced by Plaintiff's recognition of taxable income on its Federal income tax return for the taxable year ending June 30, 1976. The total amount of the liability of Plaintiff for progressive jackpot amounts which were accrued but unpaid decreased from June 30, 1975 to June 30, 1976, resulting in the recognition of such taxable inccome.

(4) The Internal Revenue Service disallowed Plaintiff's deductions claimed for the accrued progressive slot machine liability of Plaintiff for its taxable years ending June 30, 1973, 1974, 1975 and 1977. The Internal Revenue Service assessed against Plaintiff Federal income tax plus interest, based on the determination by the Internal Revenue Service that Plaintiff could not deduct currently the guaranteed jackpot on progressive slot machines for the fiscal years ending June 30, 1973, 1974, 1975

and 1977. Plaintiff paid to the Internal Revenue Service the Federal income tax and interest assessments. Plaintiff timely filed with the Internal Revenue Service formal claims for refund of such Federal income taxes and interest assessed by the Internal Revenue Service and paid by the Plaintiff. An officer of Plaintiff, who was authorized to sign, executed and delivered to the Internal Revenue Service Waivers of Statutory Notification of Claim Disallowance (Forms 2297) waiving the requirement under Section 6532(a)(1) of the Internal Federal Revenue Code of 1954 as amended (the "Code"), that a notice of claim disallowance be sent to Plaintiff by certified or registered mail for the claims for refund.

(5) At all times relevant to this action, Plaintiff has been licensed by the State of Nevada to engage in the business of gaming. As a licensed gaming establishment, Plaintiff has been subject to all of the statutes, regulations and policies enacted by the State of Nevada, the Nevada Gaming Commission, and the Nevada Gaming Control Board for the regulation of gaming establishments.

(6) During its fiscal years ending June 30, 1973, 1974, 1975 and 1977, Plaintiff owned and operated, on its casino floor, progressive slot machines. A progressive slot machine operates in the same manner as a non-progressive slot machine, except that the progressive jackpot amounts indicated on a progressive slot machine increase in direct relation to the amount of money put into the machine by customers. A non-progressive slot machine pays jackpots of fixed amounts when the designated combinations of symbols appear on the face of the slot machine. A progressive slot machine

also pays fixed amount jackpots when designated combinations of symbols appear; however, a progressive slot machine also pays progressive jackpots which increase in amount from the initial setting of the progressive jackpot indicator in direct proportion to the amount of money put into the machine by customers, and continue to increase until the progressive jackpot is won by a customer, or until the maximum progressive jackpot amount, if any, is reached. The amount registered on the meter for a progressive slot machine is referred to as the "guaranteed jackpot."

During the taxable years at issue, Plaintiff owned various types of progressive slot machines. Plaintiff operated progressive slot machines having nickel, dime, quarter, half dollar and dollar denominations. Some progressive slot machines are single coin machines; that is, only one coin may be played for each handle pull. All other progressive slot machines are multiple coin machines which accept one to five coins for each handle pull. On some of the multiple coin progressive slot machines, a customer will only have a chance at the progressive jackpot amount if he plays the maximum number of coins acceptable by the machine. In addition, some progressive slot machines indicate two progressive jackpot amounts and are referred to in the gaming industry as double progressive slot machines. On some double progressive slot machines, the availability of one progressive jackpot amount versus the other progressive jackpot amount depends upon the number of coins put into the machine by the customer, whereas on others the availability of one progressive jackpot versus the other alternates with each handle pull by a customer.

On the double progressive slot machines, only one progressive jackpot may be won at any one time; however, the second jackpot must remain available to be won by the customers after the first jackpot is paid.

(7) A progressive jackpot is won when the required combination of symbols appears on the face of the machine, and, in the case of multiple coin progressive slot machines, when the required number of coins has been put in the machine by the customer. The odds of winning a progressive jackpot are determined by the number of reels, the number of positions on each reel where the reel may stop, and the number of winning symbols which are placed on each reel. The amount of the progressive jackpot is indicated on the face of the machine by a meter which automatically increases in amount as coins are placed in the machine.

(8) Prior to September 1972, the Nevada Gaming Commission had no regulations governing the use of progressive slot machines. In September 1972, the Nevada Gaming Commission adopted Regulation § 5.110, regulating the use of progressive slot machines by licensed gaming establishments. Subsection 5 of Nevada Gaming Regulation § 5.110, as in effect during the taxable years at issue, requires licensed gaming establishments to maintain records which record the amount of the indicated payoff (meter reading) at least once per day. In addition, subsection 5 requires the gaming establishment to maintain supporting documents explaining any reduction in the payoff amount from a previous entry.

In accordance with this regulation, Plaintiff, during the taxable years at issue, maintained daily records of the amounts shown on each progressive jackpot meter. Employees of Plain-

tiff, in the ordinary course of their employment, recorded the amounts shown on each progressive jackpot meter on daily progressive slot machine report sheets.

The daily progressive slot machine report sheets during the taxable years ending June 30, 1973, 1974, 1975, 1976 and 1977, reflect that the total of the accrued but unpaid progressive slot machine jackpots has not decreased except for any decreases to reflect jackpots actually paid. The total amount of accrued but unpaid progressive slot machine jackpots of Plaintiff at the close of business on June 30, 1973, 1974, 1975, 1976 and 1977 was as follows:

Fiscal Year Ended June 30	Accrued Liability	Expense (Income)
1973	$360,228.55	$360,228.55
1974	563,983.99	203,755.44
1975	853,584.22	289,600.23
1976	839,400.97	(14,183.25)
1977	888,820.67	49,419.70

The expense amounts indicated for taxable years ended June 30, 1973, 1974, 1975 and 1977 [are the amounts] Plaintiff claim[ed] as a deduction on its Federal income tax returns for such taxable years and are the amounts which Plaintiff claims entitle it to a refund of Federal income taxes. The amounts include the accrued but unpaid progressive slot machine jackpots indicated on both jackpot meters of the double progressive slot machines which were in play on June 30, 1973, 1974, 1975 and 1977.

(9) During the taxable years of Plaintiff ending June 30, 1973, 1974, 1975 and 1977, Plaintiff maintained its books and records and reported for Federal income tax purposes on the accrual method of accounting, except for casino receivables, bad debts, vacation pay and

property taxes which were reported on a cash basis.

(10) As long as the licensed gaming establishment remains subject to the jurisdiction of the Nevada Gaming Commission, the licensed gaming establishment cannot avoid the ultimate payment of the accrued progressive slot machine jackpot.

(11) Pursuant to § 463.310.4 of the Nevada Revised Statutes, administrative penalties may be imposed against any licensed gaming establishment which wrongfully refuses to pay a progressive slot machine jackpot which has been won by a customer. Section 463.310.4 of the Nevada Revised Statutes, effective during the taxable years at issue, stated the following penalties for failure to pay a progressive jackpot won by a customer:

> 4. After the provisions of subsections 1, 2 and 3 above have been complied with, the commission shall have full and absolute power and authority to:
>
> (a) Limit, condition, suspend or revoke the license of any licensed gaming establishment or the individual license of any licensee without affecting the license of the establishment;
>
> (b) Order a licensed gaming establishment to keep an individual licensee from the premises of such licensed gaming establishment or not to pay such licensee any remuneration for services or any profits, income or accruals on his investment in such licensed gaming establishment; and
>
> (c) Fine a licensed gaming establishment in an amount not to exceed

> $100,000.00 for the first violation by such establishment, or any individual licensee in an amount not to exceed $50,000.00 for the first violation by such individual, for any cause deemed reasonable by the commission. All fines shall be paid to the state treasurer for deposit in the general fund in the state treasury.

(12) During the taxable year of Plaintiff ending June 30, 1973, the Nevada Gaming Commission adopted Regulation § 5.110 regulating the use of progressive slot machines by licensed gaming establishments. Regulation § 5.110, adopted in September 1972, reads as follows:

> 1. This paragraph shall apply to any slot machine with a payoff indicator which has a payoff that increases as the machine is played.
>
> 2. No payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player, or unless the change in the indicator reading is necessitated through a machine malfunction, in which case an explanation must be entered on the daily report as required in subsection 5.
>
> 3. If the payoff indicator progresses without a payoff until the indicators return to zero, some means must be utilized to add another digit, unless a dollar limit has been posted on the machine clearly visible to the player, and which was posted before any payoff was registered on the indicator. When the limit has been reached

> it must be permitted to remain until won by a player.
>
> 4. Once a payoff amount appears on an indicator, the rate of progression may not be changed until there has been a winner, and the indicator is returned to zero.
>
> 5. Records shall be maintained which record the amount of the indicated payoff at least once per day. Supporting documents shall be maintained to explain any reduction in the payoff amount from the previous entry. Such records and documents shall be retained for a period of three years unless permission to destroy them earlier is given by the board in writing.

This regulation was subsequently amended, effective March 1, 1977. As amended, Regulation § 5.110 reads as follows:

> 1. Applicability. This regulation shall apply to any slot machine with a payoff indicator which has a payoff that increases as the machine is played.
>
> 2. Limits. A licensee may impose a limit on the jackpot of a progressive slot machine so long as the limit imposed is greater than the possible maximum jackpot payout showing on the machine at the time the limit is imposed. Progressive slot machines upon which a limit has been imposed by the licensee must have a sign posted predominately [*sic*] upon it informing the public of the limit imposed.
>
> 3. Cash requirements. Licensees who operate under a restricted license or who are classified as a Group II nonrestricted licensee must maintain a minimum cash

reserve equal to the total of all progressive slot machine jackpots which may be won at the location. Nonrestricted Group I gaming licensees shall at all times maintain sufficient cash or cash equivalents to provide payment of all progressive jackpots offered to the public as prizes.

4. Payoff indicators. No payoff indicator shall be turned back to a lesser amount unless one of the following circumstances occur:

(a) The amount shown on the progressive meter is paid to a player as a jackpot; or

(b) It becomes necessary to adjust the progressive meter to prevent the jackpot indicator from displaying an amount greater than the limit imposed by the licensee pursuant to paragraph 2 of this regulation; or

(c) It becomes necessary to change the jackpot indicator because of machine malfunction, in which case an explanation must be entered on the daily report as required by paragraph 6 of this regulation.

5. Payoff required. Once a payoff amount apppears on a jackpot indicator, the progressive meter may not be decreased except as allowed by this regulation. A progressive jackpot may be transferred to another progressive machine at the same location in the event of machine malfunction, replacement, or for other good reasons. When the maximum jackpot limit is reached, it must be permitted to remain until won by a player.

6. Records. Records shall be maintained which record the amount shown on each progressive jackpot meter at least one time daily. Supporting documents shall be maintained to explain any reduction in the payoff amount from the previous entry. Such records and documents shall be retained for a period of five years unless permission to destroy them earlier is given by the board in writing.

7. Effective date. This regulation shall become effective on March 1, 1977, and shall apply to all licensees affected who are then or thereafter licensed.

(13) During the taxable years ending June 30, 1973, 1974, 1975, 1976 and 1977, the Nevada Gaming Commission had no restrictions on the transferability of the accrued but unpaid progressive slot machine liability on one progressive slot machine to another slot machine.

(14) The deduction of the accrued but unpaid progressive slot machine jackpot liability of Plaintiff as of June 30, 1973, 1974, 1975 and 1977, as an expense in arriving at taxable income would not distort the taxable income of Plaintiff.

(15) For the taxable years ending June 30, 1973, 1974, 1975 and 1977, the gross operating income of Harolds Club from its gaming transactions, after deducting all amounts won by customers in gaming transactions, but prior to the deduction of the accrued progressive slot machine liability, and the net income of Harold's Club from all of its activities, after deducting all expenses except the accrued pro-

gressive slot machine jackpot liability, were as follows:

Taxable Years Ending June 30	Gross Income From Gaming	Net Income From All Activities
1973	$20,367,609	$4,836,429
1974	20,859,135	5,512,863
1975	21,133,604	4,616,157
1976	23,299,066	6,901,156
1977	23,571,332	5,896,078

(c) A memorandum of contentions of fact and law is attached hereto.

(d) (1) A list setting forth the name, address and occupation of each of the prospective witnesses whom the Plaintiff proposes to call, and a succinct statement of the issue or issues to which the testimony of each witness will relate follows:

A. (1) Name:

Mr. A. J. Hicks

(2) Occupation:

Attorney (Formerly Deputy Attorney General Chief, Gaming Division, State of Nevada)

(3) Address:

McDonald, Carano, Wilson, Bergin,
Frankovich & Hicks
241 Ridge Street
Reno, Nevada 89505

(4) Issue:

A customer of a licensed gaming establishment has administrative remedies available to force a licensed gaming establishment to pay a gaming debt.

B. (1) Name:

Mr. Jeffrey A. Silver

(2) Occupation:

Chief Operations Officer, Landmark Hotel and Casino (Formerly a Member of the Gaming Control Board of the State of Nevada)

(3) Address:

Landmark Hotel and Casino
364 Convention Center Drive
Las Vegas, Nevada 89109

(4) Issue:

The payment of accrued but unpaid progressive slot machine jackpots are fixed, rather than contingent, liabilities because Nevada Gaming Regulation § 5.110 precludes the licensed gaming establishment from avoiding payment of the jackpot.

C. (1) Name:

Mr. John. H. Stratton

(2) Occupation:

Retired (Formerly a Member of the Gaming Control Board of the State of Nevada)

(3) Address:

1415 Mountain Street
Carson City, Nevada 89701

(4) Issue:

The payment of accrued but unpaid progressive slot machine jackpots are fixed, rather than contingent, liabilities because the policy of the Nevada Gaming Control Board is, and during taxable years at issue was, that upon any sale or other disposition of the entire gaming estab-

lishment, the accrued but unpaid progressive slot machine jackpots must either be paid to customers prior to the sale or assumed by the buyer following the sale.

D. (1) Name:

Mr. Peter Echeverria

(2) Occupation:

Attorney (Formerly a Member and Chairman of the Gaming Commission of the State of Nevada)

(3) Address:

Echeverria and Osborne
555 South Center Street
Reno, Nevada 89501

(4) Issue:

During the taxable years in issue, the payment of the accrued but unpaid progressive slot machine jackpot liability could not be avoided by the sale of the gaming business prior to the time that customers won the jackpots because pursuant to the policies of the Nevada Gaming Commission, the liability must have either been paid prior to the sale or assumed by the buyer.

E. (1) Name:

Mr. Philip P. Hannifin

(2) Occupation:

Senior Vice President, Summa Corporation (Formerly Chairman of the Gaming Control Board of the State of Nevada)

(3) Address:

Summa Corporation
4045 South Spencer Street
Las Vegas, Nevada 89109

(4) Issue:

(a) The payment of the liability for accrued but unpaid progressive slot machine jackpots is not subject to a contingency because Nevada Gaming Regulation § 5.110 precludes the licensed gaming establishment from avoiding payment of the jackpots.

(b) The accrued but unpaid progressive slot machine jackpots are fixed rather than contingent liabilities and the winning pull of the handle of the progressive slot machine determines solely the time of the payment of the liability and the identity of the payee.

(c) The amount of the liability for accrued but unpaid progressive slot machine jackpots can be determined with complete accuracy because the amount of the liability can be determined by reading the payoff indicator on the machine, which states the exact amount of the jackpot for that machine at that particular time.

(d) Upon the adoption of Gaming Regulation § 5.110 by the Nevada Gaming Commission in September of 1972, the amount accrued for each progressive slot machine became a fixed liability because the Plaintiff could not avoid the liability by removing the machine from the casino floor.

F. (1) Name:

Mr. Philip D. Griffith

(2) Occupation:

President, Harolds Club

(3) Address:

250 North Virginia Street
Reno, Nevada 89501

(4) Issues:

(a) Considering the magnitude of the Plaintiff's investment in Harolds Club, and the success and financial condition of the Plaintiff as of the end of the taxable years at issue and as of the present time, the possibility of the Plaintiff avoiding the payment of the accrued but unpaid progressive slot machine jackpots by surrendering its gaming license and discontinuing its gaming operations is extremely remote and speculative.

(b) Considering the financial condition of the Plaintiff at the end of the taxable years at issue, the possibility of the Plaintiff avoiding payment of the liability by becoming bankrupt was also extremely remote.

G. (1) Name:

Mr. Gene Harris

(2) Occupation:

Certified Public Accountant

(3) Address:

Deloitte, Haskins & Sells
1200 Travis
Houston, Texas 77002

(4) Issue:

The reporting of unpaid progressive slot machine jackpots as accrued liabilities results in a proper matching of revenues and expenses, and this accounting method conforms with generally accepted accounting principles.

(2) The preferred date for the beginning of the trial is November 15, 1983, and the preferred place therefor is Los Angeles, California.

(3) The approximate time that will be required for the direct examination of the Plaintiff's witnesses is four (4) days.

Respectfully submitted,

/s/ Denton N. Thomas
DENTON N. THOMAS
ANDREWS & KURTH
4200 Texas Commerce Tower
Houston, Texas 77002
(713) 220-4200
Attorney for Plaintiff

Of Counsel:

O. Clayton Lilienstern
Andrews & Kurth
4200 Texas Commerce
Houston, Texas 77002
(713) 220-4080

PLAINTIFF'S MEMORANDUM OF CONTENTIONS OF FACT AND LAW

Contentions of Fact

1. The Nevada Gaming Regulations are binding upon all licensed gaming establishments in the State of Nevada. (Philip P. Hannifin.)

2. On July 1, 1972, there were no regulations pertaining to progressive slot machines. At that point in time, the amount accrued for each machine was not a fixed liability because the Plaintiff could avoid the liability by removing the machine from the casino floor. Upon the adoption of Gaming Regulation § 5.110 in September of 1972, the liability became fixed. (Philip P. Hannifin; State of Nevada Gaming Commission Regulation 5, as adopted in September 1972.)

3. Once the increased jackpot amount is displayed on the progressive slot machine, the increased jackpot amount becomes a fixed liability which cannot be avoided. Nevada Gaming Regulation § 5.110 precludes the licensed gaming establishment from avoiding payment of the accrued but unpaid progressive slot machine jackpot. Under that Regulation, the amount of the accrued but unpaid progressive slot machine jackpot may be transferred to another progressive slot machine on the casino floor; however, the amount of the liability may not be reduced until the jackpot is paid, and the machine may not be removed from the floor (except for brief repairs) without either paying the accrued jackpot or transferring the accrued jackpot to one or more of the progressive slot machines which remain on the casino floor. (Jeffrey A. Silver; State of Nevada Gaming Commission Regulation 5, as adopted in September, 1972; State of Nevada Gaming Commission Regulation 5, as amended effective March 1, 1977; Letter dated August 20, 1976 from Mr. Jeffrey A. Silver.)

4. A customer of a licensed gaming establishment has administrative remedies available to force the licensed gaming establishment to pay a gaming debt. If a licensed gaming establishment refuses to pay a gaming debt, including a progressive slot machine jackpot, to a customer who has properly won the game, prize, or jackpot, the Nevada Gaming Commission may impose sanctions, including fines and/or the suspension or revocation of the gaming license. (A.J. Hicks; Nevada Revised Statutes §§ 463.310, 463.312 and 463.315; Letter dated February 2, 1978 from Mr. A. J. Hicks.)

5. If a licensed gaming establishment proposed to discontinue the use of a progressive slot machine, the policy of the Nevada Gaming Control Board and Nevada Gaming Commission during the taxable years at issue was to require the gaming establishment to either (a) continue the progressive slot machine in play until the progressive jackpot had been paid to a winning customer or (b) transfer the progressive jackpot amount to another progressive slot machine remaining in play at the licensed gaming establishment. (John H. Stratton and Peter Echeverria.)

6. If a licensed gaming establishment proposed a sale or other disposition of the entire gaming business, the policy of the Nevada Gaming Control Board and Nevada Gaming Commission during the taxable years at issue was to require the buyer to continue the progressive slot machines in play following the sale or other disposition with the same or greater progressive jackpot amounts as at the time of the sale until the jackpots were won by customers of the buyer. Whether or not the sales price for the gaming business was adjusted to reflect the assumption of the progressive slot machine liabilities was a subject of contractual negotiations between the buyer and seller. The policy of the Nevada Gaming Control Board and Nevada Gaming Commission as of June 30, 1973 through June 30, 1977, was to not approve the sale or other disposition unless adequate provision was made for the payment of the progressive slot machine liabilities prior to the sale or the assumption of the liabilities by

the buyer following the sale. (John H. Stratton and Peter Echeverria.)

7. Because of the severity of the sanctions which are available to the Nevada Gaming Commission if a licensed gaming establishment wrongfully refuses to pay a progressive slot machine jackpot which is won by a customer, there exists a means of enforcement which is as severe as and the equivalent of legal enforceability. With respect to a gaming debt owed by a licensed gaming establishment to a customer, administrative remedies are available to the customer. However, with respect to a gaming debt owed by a customer to a licensed gaming establishment, there are neither administrative nor legal remedies available to the licensed gaming establishment. (A. J. Hicks, Nevada Revised Statutes §§ 463.310, 463.312 and 463.315; Letter dated February 2, 1978 from Mr. A. J. Hicks.)

8. The payment of any portion of the accrued progressive slot machine jackpots cannot be avoided at least as long the the Plaintiff remains in the gaming business. Only the payment of the accrued jackpot, the bankruptcy of the Plaintiff, or the surrender of its gaming license could relieve it of its obligation. If the Plaintiff were to surrender its gaming license, it would no longer be subject to the gaming laws and regulations and could thus avoid the payment of the liability. However, considering the magnitude of the Plaintiff's investment in Harolds Club, and the success and financial condition of the Plaintiff as of the end of the taxable years at issue and as of the present time, the possibility of the Plaintiff discontinuing its gaming operations certainly is extremely remote and speculative. The only other circumstance under which the Plaintiff could avoid the payment of the liability would be if the Plaintiff became bankrupt. Once again, however, considering the financial condition of the Plaintiff at the end of the taxable years at issue, such a possibility certainly was extremely remote. (Philip D. Griffith;

Audited financial statements of Plaintiff for fiscal years ending June 30, 1973, 1974, 1975, 1976 and 1977.)

9. The winning pull of the handle of the progressive slot machine determines solely the time of the payment of the liability and the identity of the payee. (Phillip P. Hannifin.)

10. The amount of the accrued but unpaid progressive slot machine jackpot liability can be determined by reading the payoff indicator on the machine. The payoff indicator states the exact amount of the accrued but unpaid progressive slot machine jackpot for that machine at that point in time. The amount of the accrued liability can be determined with reasonable accuracy. (Philip P. Hannifin.)

11. The volume of play on the progressive slot machines of Plaintiff, the odds of a customer winning the progressive jackpot, and the fact that all of the accrued progressive jackpots of Plaintiff as of June 30, 1977, have been paid establish that there does exist a reasonable expectancy of payment of all of the accrued progressive slot machine jackpots which were on the casino floor. (Philip D. Griffith; Schedule of guaranteed jackpot payouts on Harolds Club's 4-reel progressive slot machines from September 9, 1971 to September 1, 1976; Schedule of Harolds Club's progressive slot machines liabilities as of June 30, 1977, and subsequent guaranteed jackpot payments).

12. The reporting of accrued but unpaid progressive slot machine jackpots as accrued liabilities and any increases in the accrued liabilities as a reduction of the slot machine gross profit of the licensed gaming establishment conforms with generally accepted accounting principles, results in a proper matching of revenues and expenses, and clearly reflects income. Since all subsequent increases in the amount of the jackpot must result from play on the machine and the corresponding recognition of taxable income by the casino, there could be no distortion of income resulting from the deduction of the

subsequent accrual. To require the deduction to be deferred until the year of actual payment rather than the year in which the liability accrues could result in a material distortion of taxable income for the year of payment. (Gene Harris; Audited financial statements of Plaintiff for the fiscal years ending June 30, 1973, 1974, 1975, 1976 and 1977.)

13. The accrued progressive slot machine liability of Plaintiff is incurred in the year in which the related income is earned. The accrual of the liability results in a proper matching of revenues and expenses. (Gene Harris; Audited financial statements of Plaintiff for the fiscal years ending June 30, 1973, 1974, 1975, 1976 and 1977.)

Contentions of Law

1. This Court has jurisdiction of the subject matter of this action pursuant to 28 U.S.C., Section 1346(a)(1).

2. Section 162 of the Internal Revenue Code of 1954, as amended (the "Code"), permits the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

3. The amounts payable by Plaintiff to its gaming customers as a result of gaming transactions, including progressive slot machine jackpots, fall within the definition of ordinary and necessary expenses incurred in carrying on its gaming business and are deductible under Code Section 162.

4. The accrued but unpaid liability for progressive slot machine jackpots constitutes an "ordinary and necessary business expense," the deductibility of which is determined under Sections 162 and 461 of the Code.

5. There is a liability created for purposes of Reg. § 1.461-1(a)(2) at the point at which there is an obligation or duty to perform an act and the cost of performance is measurable in money.

Crescent Wharf and Warehouse Co. v. Commissioner, 518 F.2d 772, 75-2 USTC ¶ 9571 (9th Cir. 1975)

6. An accrued but unpaid progressive slot machine jackpot liability satisfies the requirements of Code Section 461 and Reg. § 1.461-1(a)(2) for the deduction of accrued liabilities by an accrual basis taxpayer.

7. In the case of progressive slot machine jackpots, the amount of the accrued but unpaid liability can be determined in money with reasonable accuracy in the year in which it is accrued in accordance with Reg. § 1.461-1(a)(2).

8. All the events have occurred which determine the fact that the Plaintiff has incurred a liability under Reg. § 1.461-1(a)(2).

9. The accrued but unpaid progressive slot machine jackpots are allowable deductions because in the taxable years in which the deductions were taken, all the operative facts giving rise to the obligation had occurred.

Harrold v. Commissioner, 192 F.2d (1002, 52-1 USTC ¶ 9107 (4th Cir. 1951)

Denise Coal Company v. Commissioner, 217 F.2d 930, 59-2 USTC ¶ 9769 (3d Cir. 1959).

10. A licensed gaming establishment is not precluded from deducting accrued but unpaid progressive slot machine jackpots until the actual payment of the gaming debt. The requirement for accruability is that there be a reasonable expectancy that the payment will be made.

Flamingo Resort, Inc. v. United States, 664 F.2d 1387 (9th Cir. 1982), *aff'g* 485 F. Supp. 926, 80-1 USTC ¶ 9312 (D. C. Nev. 1980)

Eastman Kodak Co. v. United States, 534 F.2d 252, 76-1 USTC ¶ 9363 (Ct. Cl. 1976)

Champion Spark Plug Co. v. Commissioner, 30 T. C. 295 (1958), *aff'd* 266 F.2d 347 (6th Cir. 1959)

Barker v. Magruder, 95 F.2d 122, 38-1 USTC ¶ 9052 (D. C. Cir. 1938)

Barker v. United States 26 F.Supp. 1004, 39-1 USTC ¶ 9437 (Ct. Cl. 1939)

Travis v. Commissioner, 406 F.2d 987, 69-1 USTC ¶ 9213 (6th Cir. 1969)

11. The liability for accrued but unpaid progressive slot machine jackpots is a fixed and definite, rather than contingent, liability because the licensed gaming establishment is precluded from avoiding payment by the Nevada Gaming Regulations, which are binding upon all licensed gaming establishments in Nevada.

Nevada Gaming Regulation § 5.110.

12. Even if the winning pull of the handle of the progressive slot machine were regarded as a contingency, the contingency is not the type which would preclude the deduction. A liability satisfies the all events test for Federal income tax purposes even though there exist contingencies relating to the liability if there is a reasonable certainty of payment and the amount of the liability is definitely ascertainable.

Washington Post Company v. United States, 405 F.2d 1279, 69-1 USTC ¶ 9192 (Ct. Cl. 1969)

Clark v. Woodward Construction Company, 179 F.2d 176, 50-1 USTC ¶ 9133 (10th Cir. 1950)

13. The accrued liability may be recognized for Federal income tax purposes if there exists, at the end of the taxable years at issue, a reasonable expectancy of payment of the amount.

Flamingo Resort Inc. v. United States, supra

United Control Corporation, 38 T. C. 957 (1962)

Harbor Plywood Corporation v. Commissioner, 187 F.2d 734, 51-1 USTC ¶ 9222 (9th Cir. 1951), *aff'g* 14 T. C. 158 (1950)

H. Liebes and Company v. Commissioner, 90 F.2d 932, 37-3 USTC ¶ 9361 (9th Cir. 1937)

Zwicker Knitting Mills v. United States, 80-2 USTC ¶ 9832 (Ct. Cl. 1980)

14. Although a reasonable expectancy of the payment of the liability is required, absolute certainty of its eventual payment is not required for the accrual of an expense for Federal income tax purposes by an accrual basis taxpayer.

Keebey's, Inc. v. Paschal, 188 F.2d 113, 51-1 USTC ¶ 9235 (8th Cir. 1951)

Zimmerman Steel Company v. Commissioner, 130 F.2d 1011, 42-2 USTC ¶ 9697 (8th Cir. 1942)

Clark v. Woodward Construction Company, supra

Washington Post Company v. United States, supra

Zwicker Knitting Mills v. United States, supra

15. A taxpayer can accrue an expense or obligation that is reasonably certain in fact even though the existence of the liability is not absolute until the occurrence of a condition in a year subsequent to the year of accrual.

Lucas v. American Code Co., 280 U.S. 445 (1930)
Gillis v. United States, 402 F.2d 501 (5th Cir. 1968)

16. An existing liability subject to possible discharge by a speculative or extremely remote future event or condition subsequent may be reasonably certain in fact and accrued if the accrual is practical in terms of the purpose of the statute and the taxpayer has a reasonable belief in the certainty of the liability.

Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969)

Helvering v. Russian Finance & Construction Corp., 77 F.2d 324 (2d Cir. 1935)

17. The test is whether the Plaintiff is justified in entertaining a reasonable expectation that the expense

will be paid. Even if the winning pull of the handle of the progressive slot machine were regarded as a contingency, such a contingency is not of the nature which would have justified the Plaintiff in believing at the time of the accrual that the obligation would not be paid in the normal course of events.

Helvering v. Russian Finance & Construction Corp., supra

18. The possibility that Plaintiff could go out of business is not the kind of possible contingency that aborts satisfaction of the all events test.

Lawyers Title Guaranty Fund v. United States, 508 F.2d (5th Cir. 1975)

19. The accrued progressive slot machine jackpots are deductible even though the time for payment of the accrued liability and the identity of the winning customer are uncertain.

Washington Post Company v. United States, supra

Inland Steel Company v. United States, 76-2 USTC ¶ 9791 (Ct. Cl. 1976)

Lukens Steel Co. v. Commissioner, 442 F.2d 1131, 71-1 USTC ¶ 9374 (3d Cir. 1971), *aff'g* 52 T. C. 764 (1969)

Cyclops Corporation v. United States, 408 F. Supp. 1287, 76-1 USTC ¶ 9179 (W. D. Pa. 1976)

Reynold Metals Co., 68 T. C. 943 (1977)

20. The accrued but unpaid progressive slot machine jackpots are deductible because a deductible liability can arise out of a state legal requirement rather than out of a contractual obligation.

Harrold v. Commissioner, supra

Denise Coal Company v. Commissioner, supra

Crescent Wharf & Warehouse Co. v. Commissioner, supra

21. The accrual of unpaid progressive slot machine jackpots as liabilities conforms with generally accepted accounting principles and results in a proper matching of revenues and expenses. Whenever possible, expenses attributable to the production of gross income should be deducted in the same year in which the income is produced. The proper matching of revenues and expenses is an important factor to be considered in determining the proper application of accrual principles.

Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955), *rev'g* 17 T.C. 1097 (1952)

United States v. Anderson, 269 U.S. 522, 70 L. Ed. 347, 1 USTC ¶ 155 (1926)

Flamingo Resort, Inc. v. United States, supra

Travis v. Commissioner, supra

Crescent Wharf & Warehouse Co. v. Commissioner, supra

NCNB Corporation v. United States, 651 F.2d 942, 81-2 USTC ¶ 9501 (4th Cir. 1981)

22. The fact that the Plaintiff's deduction of accrued but unpaid progressive jackpots accords with generally accepted accounting principles is an important factor in determining whether such accrual is acceptable for Federal income tax purposes.

Code Section 446 and Reg. § 1.446-1(c)(1)(ii)

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

CROSS-MOTION OF HUGHES PROPERTIES, INC. FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

Plaintiff, Hughes Properties, Inc., pursuant to Rule 56 of the Rules of this Court, respectfully moves for summary judgment in its favor and requests that defendant's motion for summary judgment be denied. There is no genuine issue as to any material fact, and the plaintiff is entitled to judgment as a matter of law.

In support of this cross-motion and response, plaintiff relies on the Affidavits contained in the Appendix to the brief in support of this cross-motion and response and our accompanying brief.

WHEREFORE, plaintiff prays that its cross-motion be granted and that defendant's motion be denied.

Respectfully submitted,

/s/ Denton N. Thomas
DENTON N. THOMAS
Andrews & Kurth

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

APPENDIX TO THE BRIEF FOR HUGHES PROPERTIES, INC. IN SUPPORT OF ITS CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

* * * * *

NEVADA GAMING STATUTES:

Nevada Revised Statutes § 463.310 (as in effect during the taxable years at issue)

§ 463.310 Investigations; disciplinary proceedings; powers of commission.

1. The board shall make appropriate investigations:

(a) To determine whether there has been any violation of this chapter, chapter 464 or chapter 465 of NRS or any regulations adopted thereunder.

(b) To determine any facts, conditions, practices or matters which it may deem necessary or proper to aid in the enforcement of any such law or rules and regulations.

(c) To aid in adopting regulations.

(d) To secure information as a basis for recommending legislation relating to this chapter, chapter 464 or chapter 465 of NRS.

(e) As directed by the commission.

2. If, after any investigation the board is satisfied that a license, registration, finding of suitability, pari-mutuel license or prior approval by the commission of any transaction for which such approval was required or permitted under the provisions of this chapter or chapter 464 of NRS should be limited, conditioned, suspended or revoked, it shall initiate a hearing before the commission by filing a complaint with the commission in accordance with NRS 463.312 and transmit therewith a summary of evidence in its possession bearing on the matter and the transcript of testimony at any investigative hearing conducted by or on behalf of the board.

3. Upon receipt of the complaint of the board, the commission shall review it and all matter presented in support thereof, and, if satisfied that probable grounds exist for disciplinary or other action, shall conduct further proceedings in accordance with NRS 463.312. If the commission is not satisfied that probable grounds exist for disciplinary or other action, it may order the complaint withdrawn without prejudice to the filing of another complaint after further investigation and reconsideration by the board.

4. After the provisions of subsections 1, 2 and 3 above have been complied with, the commission may:

(a) Limit, condition, suspend, or revoke the license of any licensed gaming establishment or the individual license of any licensee without affecting the license of the establishment;

(b) Limit, condition, suspend or revoke any registration, finding of suitability, pari-mutuel license, or prior approval given or granted to any applicant by the commission;

(c) Order a licensed gaming establishment to keep an individual licensee from the premises of such licensed gaming establishment or not to pay such licensee any remuneration for services or any profits, income or accruals on his investment in such licensed gaming establishment; and

(d) Fine the licensee, registrant, person or entity previously found suitable, pari-mutuel licensee, or person or entity who previously obtained approval for any act or transaction for which commission approval was required or permitted under the provisions of this chapter or chapter 464 of NRS, not more than $100,000 for the first violation and not more than $250,000 for each subsequent violation of the provisions of this chapter, chapter 464 or chapter 465 or NRS or of the regulations of the commission.

All fines shall be paid to the state treasurer for deposit in the general fund.

* * * * *

NEVADA GAMING REGULATIONS:

Reg. § 5.110 Progressive Slot Machines. (As adopted September 1972)

1. This paragraph shall apply to any slot machine with a payoff indicator which has a payoff that increases as the machine is played.

2. No payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player, or unless the change in the indicator reading is necessitated through a machine malfunction, in which case an explanation must be entered on the daily report as required in subsection 5.

3. If the payoff indicator progresses without a payoff until the indicators return to zero, some means must be

utilized to add another digit, unless a dollar limit has been posted on the machine clearly visible to the player, and which was posted before any payoff was registered on the indicator. When the limit has been reached it must be permitted to remain until won by a player.

4. Once a payoff amount appears on an indicator, the rate of progression may not be changed until there has been a winner, and the indicator is returned to zero.

5. Records shall be maintained which record the amount of the indicated payoff at least once per day. Supporting documents shall be maintained to explain any reduction in the payoff amount from the previous entry. Such records and documents shall be retained for a period of three years unless permission to destroy them earlier is given by the board in writing.

Reg. § 5.110 Progressive Slot Machines. (As amended March 1 1977)

1. *Applicability.* This regulation shall apply to any slot machine with a payoff indicator which has a payoff that increases as the machine is played.

2. *Limits.* A licensee may impose a limit on the jackpot of a progressive slot machine so long as the limit imposed is greater than the possible maximum jackpot payout showing on the machine at the time the limit is imposed. Progressive slot machines upon which a limit has been imposed by the licensee must have a sign posted predominately [*sic*] upon it informing the public of the limit imposed.

3. *Cash requirements.* Licensees who operate under a restricted license or who are classified as a Group II nonrestricted licensee must maintain a minimum cash reserve equal to the total of all progressive slot machine jackpots which may be won at the location. Nonrestricted Group I gaming licensees shall at all times maintain sufficient cash or cash equivalents to provide payment of all progressive jackpots offered to the public as prizes.

4. *Payoff indicators.* No payoff indicator shall be turned back to a lesser amount unless one of the following circumstances occur:

(a) The amount shown on the progressive meter is paid to a player as a jackpot; or

(b) It becomes necessary to adjust the progressive meter to prevent the jackpot indicator from displaying an amount greater than the limit imposed by the licensee pursuant to paragraph 2 of this regulation; or

(c) It becomes necessary to change the jackpot indicator because of machine malfunction, in which case an explanation must be entered on the daily report as required by paragraph 6 of this regulation.

5. *Payoff required.* Once a payoff amount appears on a jackpot indicator, the progressive meter may not be decreased except as allowed by this regulation. A progressive jackpot may be transferred to another progressive machine at the same location in the event of machine malfunction, replacement, or for other good reason. When the maximum jackpot limit is reached, it must be permitted to remain until won by a player.

6. *Records.* Records shall be maintained which record the amount shown on each progressive jackpot meter at least one time daily. Supporting documents shall be maintained to explain any reduction in the payoff amount from the previous entry. Such records and documents shall be retained for a period of five years unless permission to destroy them earlier is given by the board in writing.

7. *Effective date.* This regulation shall become effective on March 1, 1977, and shall apply to all licensees affected thereby who are then or thereafter licensed.

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF PETER ECHEVERRIA IN SUPPORT OF PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

STATE OF NEVADA)
) ss.
COUNTY OF WASHOE)

Peter Echeverria, being duly sworn, deposes and says:

1. I have been licensed as an attorney at law in the State of Nevada since 1949. From April 27, 1973, through April 27, 1977, I served as a member of the Nevada Gaming Commission, and I served as Chairman of the Nevada Gaming Commission from October 1, 1973, through April 27, 1977. As a member of the State Bar of Nevada and as past Chairman of the Nevada Gaming Commission, I am familiar with the Nevada gaming laws and regulations and the policies of the Nevada Gaming Control Board and the Nevada Gaming Commission.

2. Under Nevada law as in effect from June 30, 1973, through June 30, 1977, the Nevada Gaming Control Board had the authority to enforce the regulations of the

Nevada Gaming Commission which regulated the activities of licensed gaming establishments in the State of Nevada. Included within the authority of the Nevada Gaming Control Board was the enforcement of Nevada Gaming Regulation § 5.110.5, as then in effect, relating to the use of progressive slot machines by licensed gaming establishments.

3. Section 463.310.4 of the Nevada Revised Statutes and Regulation 7 of the Nevada Gaming Regulations, as in effect from June 30, 1973, through June 30, 1977, permitted the Nevada Gaming Commission to impose severe sanctions, including fines and/or revocation or suspension of the gaming license, if a licensed gaming establishment wrongfully refused to pay a progressive slot machine jackpot which was won by a customer.

4. If a licensed gaming establishment proposed to discontinue the use of a progressive slot machine, the policy of the Nevada Gaming Control Board and the Nevada Gaming Commission as of June 30, 1973, through June 30, 1977, was to require the gaming establishment to either (a) continue the progressive slot machine in play until the progressive jackpot had been paid to a winning customer or (b) transfer the progressive jackpot amount to another progressive slot machine remaining in play at the licensed gaming establishment.

5. If a gaming establishment proposed a sale or other disposition of the entire gaming business, the policy of the Nevada Gaming Control Board and the Nevada Gaming Commission from June 30, 1973, through June 30, 1977, was to require the buyer to continue the progressive slot machines in play following the sale or other disposition with the same or greater progressive jackpot amounts as at the time of the sale until the jackpots were won by customers of the buyer. Whether or not the sales price for the gaming business was to be adjusted to reflect the assumption of the progressive slot machine liabilities was to be a subject of contractual negotiations between the buyer and seller. The policy of the Nevada Gaming Con-

trol Board and the Nevada Gaming Commission was not to approve the sale or other disposition unless adequate provisions were made for the payment of the progressive slot machine liabilities prior to the sale or the assumption of the liabilities by the buyer following the sale.

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 25th, 1983, in Reno, Nevada.

/s/ Peter Echeverria
PETER ECHEVERRIA

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF PHILIP D. GRIFFITH IN SUPPORT OF PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

STATE OF NEVADA)
) ss.
COUNTY OF CLARK)

Philip D. Griffith, being duly sworn, deposes and says:

1. I am employed as the President of the Harolds Club division of Hughes Properties, Inc., a Nevada corporation doing business as Harolds Club.

2. As the President of the Harolds Club division, I am responsible for the compliance by Hughes Properties, Inc. with all of the Nevada gaming regulations affecting slot machines, including progressive slot machines. Nevada Gaming Regulation § 5.110.5 requires that the amount of the accrued but unpaid progressive slot machine jackpots be recorded at least once per day. At Hughes Properties, Inc., the amount of the accrued but unpaid progressive slot machine jackpots is recorded once during each of the three shifts during each day. The amount is

recorded on a progressive slot machine daily report. At the close of business on June 30, 1973, 1974, 1975, 1976, and 1977, the progressive slot machine daily report indicated that the total amount of the then accrued but unpaid progressive slot machine jackpots of Hughes Properties, Inc. was as follows:

Fiscal Year Ended June 30	Accrued Liability
1973	$360,228.55
1974	563,983.99
1975	853,584.22
1976	839,400.97
1977	888,820.67

The progressive slot machine daily reports for such shifts were, in my opinion, properly prepared by the employees of Hughes Properties, Inc., in the ordinary course of their employment. Accordingly, the total amount of the accrued but unpaid progressive slot machine jackpots indicated thereon was the accurate amount of the then accrued but unpaid progressive slot machine jackpots of Hughes Properties, Inc.

3. All of the accrued but unpaid progressive slot machine jackpots as of June 30, 1977 were subsequently won and paid to customers of the corporation. The average period of time between Harolds Club's payoffs on a progressive slot machine's guaranteed jackpot is approximately 4.5 months. This determination was made as of September 1, 1976, for the twenty-four (24) 4-reel progressive slot machines then in operation. All but two of these machines were installed prior to 1974. With the exception of two machines, one of which had been in operation thirteen (13) months and the other thirty-five (35) months that did not pay off prior to September 1, 1976, the payoff frequency ranged from a high of 14.3 months to a low of 1.9 months. As of September 1, 1976, Harolds Club also operated ninety-two (92) 3-reel progressive slot machines. The average number of "plays"

required for a payoff on these machines is significantly lower than that of the 4-reel machines.

4. Hughes Properties, Inc. has had a long history of success in the gaming business, and there was absolutely no expectation of the discontinuance by the corporation of its gaming business or the surrender of its gaming license during or following the taxable years in question. To the contrary, as evidenced by the magnitude of the investment in Harolds Club by Hughes Properties, Inc., the corporation intended to continue its gaming business for an indefinite period in the future.

5. Considering the financial condition of Hughes Properties, Inc. at the end of the taxable years at issue, the possibility of Hughes Properties, Inc. becoming bankrupt was also extremely remote and speculative.

6. In my opinion, during the entire taxable years ending June 30, 1973, 1974, 1975, 1976, and 1977, all of the requirements of Nevada Gaming Regulation § 5.110 pertaining to progressive slot machines were complied with by Hughes Properties, Inc. There were no instances in which a progressive slot machine was removed from the casino floor without the amount of the accrued but unpaid progressive jackpot being transferred to one or more of the remaining progressive slot machines, other than occasional instances when a progressive slot machine was briefly removed from the casino floor for routine repairs and maintenance. Whenever a progressive slot machine is removed from the casino floor for repairs and maintenance, if the amount of the accrued but unpaid progressive jackpot is not immediately transferred to one or more of the remaining progressive slot machines, then the machine is immediately returned to the casino floor following the completion of the repairs or maintenance with the same amount of accrued but unpaid jackpot as prior to the removal from the casino floor. Unless the repairs and maintenance can routinely be completed within one day from the time the machine is removed from the casino floor, the amount of the accrued but unpaid progressive

slot machine jackpot will be transferred to one or more of the remaining progressive slot machines at the time the machine is removed from the casino floor.

7. The rate of progression on the progressive slot machines in play at Hughes Properties, Inc. refers to the rate of increase in the amount of the accrued but unpaid progressive jackpot on each machine as such machine is played, depending on the particular machine. The rate of progression on each progressive slot machine is fixed at the time the machine is placed on the casino floor, and the rate of progression may not be subsequently changed until either the jackpot is won by a customer or the jackpot limit is reached.

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 25, 1983, in Las Vegas, Nevada.

/s/ Philip D. Griffith
PHILIP D. GRIFFITH

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF PHILIP P. HANNIFIN IN SUPPORT OF PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

STATE OF NEVADA)
) ss.
COUNTY OF CLARK)

Philip P. Hannifin, being duly sworn, deposes and says:

1. I am presently employed as Senior Vice President of Summa Corporation (4045 South Spencer Street, Las Vegas, Nevada 89109). As Senior Vice President of Summa Corporation, I am responsible for the compliance of Summa Corporation with all of the Nevada gaming regulations affecting slot machines, including progressive slot machines.

2. I was formerly Chairman of the Gaming Control Board of the State of Nevada. As such, I am familiar with the Nevada gaming laws and regulations and the policies of the Nevada Gaming Control Board and Nevada Gaming Commission.

3. The laws, regulations, and policies referred to in this affidavit were in effect from June 30, 1973, through

June 30, 1977, and have continued in effect to the present time.

4. Under Nevada law, the Nevada Gaming Control Board has the authority to enforce the regulations of the Nevada Gaming Commission which regulate the activities of licensed gaming establishments in the State of Nevada.

5. The Nevada Gaming Regulations are binding upon all licensed gaming establishments in the State of Nevada. Harolds Club is a licensed gaming establishment subject to the Nevada Gaming Regulations.

6. On July 1, 1972, there were no regulations pertaining to progressive slot machines. At that time, the amount accrued for each machine was not a fixed liability because the liability could be avoided by removing the machine from the casino.

7. Upon the adoption of Gaming Regulation § 5.110 in September of 1972, the liability for accrued but unpaid progressive slot machine jackpots became fixed. Regulation § 5.110 precludes a licensed gaming establishment from avoiding payment of accrued but unpaid progressive slot machine jackpots. Therefore, the liability for accrued but unpaid progressive slot machine jackpots is not subject to a contingency.

8. The winning pull of the handle of the progressive slot machine solely determines the time of the payment of the liability and the identity of the payee.

9. The amount of the accrued but unpaid progressive slot machine jackpot liability can be determined with reasonable accuracy by reading the payoff indicator on the machine. The payoff indicator states the exact amount of the accrued but unpaid progressive slot machine jackpot for that machine at that particular point in time.

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 25, 1983, in Las Vegas, Nevada.

/s/ Philip P. Hannifin
PHILIP P. HANNIFIN

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF GENE HARRIS IN SUPPORT OF PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

STATE OF TEXAS)
) ss.
COUNTY OF HARRIS)

Gene Harris, being duly sworn, deposes and says:

1. I am licensed by the Texas State Board of Public Accountancy as a certified public accountant. I am also a partner of the certified public accounting firm of Deloitte Haskins & Sells (formerly Haskins & Sells).

2. During the period of time that I have been a member of Deloitte Haskins & Sells, I have worked on the account of Hughes Properties, Inc. While working on the account of Hughes Properties, Inc., I assisted in the preparation of its financial statements for the fiscal years ending June 30, 1973, through June 30, 1977. As an independent certified public accountant assigned to the Hughes Properties, Inc. account I have become thoroughly familiar with the method of accounting for progressive

slot machine liabilities. Because of the fact that under the Nevada Gaming Regulations adopted in September 1972, a licensed gaming establishment may not decrease the amount of a progressive slot machine jackpot until the jackpot is won by a customer, the total amount of accrued but unpaid progressive slot machine jackpots is recorded on the financial records of the corporation as an accrued liability. As the amount of the accrued but unpaid progressive slot machine jackpot increases, the increase is recorded as a reduction of the slot machine gross profit or "win" (a debit to the "slot income" account) and as an increase in the liability account (a credit to the "progressive slot machine jackpots" account). When a progressive slot machine jackpot is won by a customer and the amount of the jackpot is paid, the liability account is reduced by the amount of the jackpot paid. The reduction is accomplished by a debit to the liability account. The corresponding credit is to the appropriate cash account. No additional reduction of the slot machine gross profit is recorded at the time the jackpot is paid.

3. The income earned with respect to each progressive slot machine is recorded when the coins deposited into the machine (the "drop") are counted. Such coins are collected from each machine and counted at least twice per week and on the last day of each calendar month. Because the amount of the liability for accrued but unpaid progressive slot machine jackpots increases in direct proportion to the volume of play on the machines, and because the income is recorded during the same period in which the play occurs and the related income is earned, the recordation of the increase in the accrued but unpaid progressive slot machine jackpots as a reduction of the slot machine gross profit in the same period results in a proper matching of revenues and expenses and clearly reflects income. Since the Nevada Gaming Regulation pertaining to progressive slot machines first became effective in September 1972, the first fiscal year of

Hughes Properties, Inc. for which the above-described accounting method was appropriate was the fiscal year ending June 30, 1973.

4. The financial statements and federal income tax return for Hughes Properties, Inc. for the fiscal year ending June 30, 1973, reported the accrued but unpaid progressive slot machine jackpots as liabilities. As of June 30, 1973, the certified public accounting firm of Haskins & Sells determined that, under generally accepted accounting principles, the accrued but unpaid progressive slot machine jackpots should be reported on the financial records of the corporation as accrued liabilities. Since that time, the accrued but unpaid progressive slot machine jackpots have been consistently reported on the financial records and federal income tax returns of the corporation as accrued liabilities. The amount of such liabilities were determined from the daily progressive slot machine reports listing the accrued but unpaid progressive slot machine jackpots as of the close of business on June 30, 1973, 1974, 1975, 1976 and 1977. The daily progressive slot machine report was prepared by employees of Hughes Properties, Inc. in the ordinary course of their employment.

5. In my opinion, the reporting of accrued but unpaid progressive slot machine jackpots as accrued liabilities and any increases in the accrued liabilities as a reduction of the slot machine gross profit conforms with generally accepted accounting principles.

6. Because all subsequent increases in the amount of the jackpot must result from play on the machines and the corresponding recognition of taxable income by the casino, there would be no distortion of income resulting from the deduction of the subsequent accrual. To require the deduction to be deferred until the actual year of payment, rather than the year in which the liability accrues, could result in a material distortion of the income of Hughes Properties, Inc. for the year of payment.

The amount of the related expense is minimal compared to the amount of income recognized.

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 25th, 1983, in Houston, Texas.

/s/ Gene Harris
GENE HARRIS

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF A. J. HICKS IN SUPPORT OF PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

STATE OF NEVADA)
) ss.
COUNTY OF WASHOE)

A. J. Hicks, being duly sworn, deposes and says:

1. I am a partner in the law firm of McDonald, Carano, Wilson, Bergin, Frankovich & Hicks, 214 Ridge Street, Reno, Nevada 89505.

2. I was formerly Deputy Attorney General, Chief, Gaming Division, State of Nevada. As former Deputy Attorney General, I am familiar with the Nevada gaming laws. The law referred to in this affidavit was in effect from June 30, 1973, through June 30, 1977, and has continued in effect to the present time.

3. A customer of a licensed gaming establishment has administrative remedies available to compel a licensed gaming establishment to pay a gaming debt. Pursuant to § 463.310 of the Nevada Revised Statutes, as in effect

during the taxable year in issue, administrative remedies could be imposed against any licensed gaming establishment which wrongfully refused to pay a gaming debt, including a progressive slot machine jackpot, to a customer who had properly won the game, prize, or jackpot. The Nevada Gaming Commission may impose severe sanctions, including fines and/or the revocation or suspension of the gaming license.

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 25, 1983, in Reno, Nevada.

/s/ A. J. Hicks
A. J. HICKS

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF JEFFREY A. SILVER IN SUPPORT OF PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

STATE OF NEVADA)
) ss.
COUNTY OF CLARK)

Jeffrey A. Silver, being duly sworn, deposes and says:

1. I am presently Chief Operations Officer of the Landmark Hotel and Casino, 346 Convention Center Drive, Las Vegas, Nevada 89109.

2. I was formerly a member of the Nevada Gaming Control Board. As a former member of the Nevada Gaming Control Board, I am familiar with the Nevada gaming laws and regulations and the policies of the Nevada Gaming Control Board and the Nevada Gaming Commission.

3. The regulations and policies referred to in this affidavit were in effect from June 30, 1973, through June 30, 1977, and have continued in effect to the present time.

The Nevada Gaming Regulations are binding upon all licensed gaming establishments in the State of Nevada.

4. Under Nevada law, the Nevada Gaming Control Board has the authority to enforce the regulations of the Nevada Gaming Commission which regulates the activities of licensed gaming establishments in the State of Nevada. Included within the authority of the Nevada Gaming Control Board is the enforcement of Nevada Gaming Regulation § 5.110 relating to the use of progressive slot machines by licensed gaming establishments.

5. Accrued but unpaid progressive slot machine jackpots are fixed liabilities because Nevada Gaming Regulation § 5.110 precludes the licensed gaming establishment from avoiding payment of the jackpot.

6. The provisions of Nevada Gaming Commission Regulation § 5.110 have been applied by the Nevada Gaming Control Board as making guaranteed jackpots fixed liabilities of the licensee. Two instances of the Board's application of this fixed liability concept are as follows:

(a) A licensee requested permission to remove a progressive slot machine from operation and replace it with a regular slot machine. The Board granted approval upon the condition that the guaranteed jackpot of the removed progressive slot machine be added to the guaranteed jackpot amount of another progressive slot machine.

(b) A licensee who initially operated as a sole proprietorship but who had subsequently acquired a partner requested permission to remove all progressive slot machines from its casino floor. Even though a new individual had become a licensee and the form of casino ownership had changed to a partnership, the Board denied permission since the guaranteed progressive jackpot had not been paid.

7. Once a progressive slot machine is placed in operation, the liability for its guaranteed jackpot cannot be avoided by removing the machine, changing the form of

the licensee's business operations or by a change of licensees.

8. Sums shown on the meter, in contrast to standard slot machines, actually represent participation by the players, a portion of their play being used to increase the award. The Board in recognizing this investment requires the licensee to be responsible for the obligation shown on the meter, and holds its accountable until the amount is actually paid.

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 25, 1983, in Las Vegas, Nevada.

/s/ Jeffrey A. Silver
JEFFREY A. SILVER

IN THE UNITED STATES CLAIMS COURT

No. 594-82 T

HUGHES PROPERTIES, INC., PLAINTIFF

v.

THE UNITED STATES, DEFENDANT

AFFIDAVIT OF JOHN H. STRATTON IN SUPPORT OF PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT AND OPPOSITION TO THE DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

STATE OF NEVADA)
) ss.
COUNTY OF WASHOE)

John H. Stratton, being duly sworn, deposes and says:

1. From July 1, 1972 through June 30, 1977, I was a member of the Nevada Gaming Control Board. As a former member of the Nevada Gaming Control Board, I am familiar with the Nevada gaming laws and regulations and the policies of the Nevada Gaming Control Board and the Nevada Gaming Commission.

2. The laws, regulations, and policies referred to in this affidavit were in effect from June 30, 1973, through June 30, 1977, and have continued in effect to the present time.

3. Under Nevada law, the Nevada Gaming Control Board has the authority to enforce the regulations of the Nevada Gaming Commission which regulates the activities of licensed gaming establishments in the State of

Nevada. Included within the authority of the Nevada Gaming Control Board is the enforcement of Nevada Gaming Regulation § 5.110.5 relating to the use of progressive slot machines by licensed gaming establishments.

4. Section 463.310 of the Nevada Revised Statutes and Regulation 7 of the Nevada Gaming Regulations permit the Nevada Gaming Commission to impose severe sanctions, including fines and/or revocation or suspension of the gaming license, if a licensed gaming establishment wrongfully refuses to pay a progressive slot machine jackpot which is won by a customer. The procedures to be followed by and the remedies available to the Nevada Gaming Control Board and the Nevada Gaming Commission upon receipt of a complaint from a customer of the alleged non-payment of a progressive slot machine jackpot are outlined below. Upon receiving a complaint from the customer of a gaming establishment, the Gaming Control Board will schedule a formal hearing and commence its investigation of the complaint. Upon completion of the investigation and the hearing, the Gaming Control Board will determine whether the gaming establishment should or should not have paid the progressive slot machine jackpot. If the Gaming Control Board determines that the gaming establishment justifiably refused to pay the progressive jackpot because of cheating by the customer or other valid reasons, the Gaming Control Board will dismiss the customer's complaint and no further action will be taken. If, however, the Gaming Control Board determines that the progressive jackpot was validly won by the customer and should have been paid and the licensee still refuses to make payment, the Gaming Control Board will either file an order to show cause against the gaming establishment or immediately file a complaint with the Nevada Gaming Commission requesting the imposition of sanctions against the licensed gaming establishment. The sanctions which the Nevada Gaming Commission is authorized to impose against the licensed gaming establishment include severe fines and/or suspension or revocation of the gaming license.

5. If a licensed gaming establishment proposes to discontinue the use of a progressive slot machine, the policy of the Nevada Gaming Control Board is to require the gaming establishment to either (a) continue the progressive slot machine in play until the progressive jackpot has been paid to a winning customer or (b) transfer the progressive jackpot amount to another progressive slot machine remaining in play at the licensed gaming establishment. If the licensed gaming establishment does not comply with these requirements, the procedures and sanctions described in paragraph 4 above are available to the Nevada Gaming Control Board and the Nevada Gaming Commission.

6. If a gaming establishment proposes a sale or other disposition of its entire gaming business, the policy of the Nevada Gaming Control Board and the Nevada Gaming Commission is to require the buyer to continue the progressive slot machines in play following the sale or other disposition with the same or greater progressive jackpot amounts as at the time of the sale until the jackpots are won by customers of the buyer. Whether or not the sale price for the gaming business is to be adjusted to reflect the assumption of the progressive slot machine liabilities is a subject of contractual negotiations between the buyer and seller. The policy of the Nevada Gaming Control Board and the Nevada Gaming Commission is to not approve the sale or other disposition unless adequate provisions are made for the payment of the progressive slot machine liabilities prior to the sale or the assumption of the liabilities by the buyer following the sale. Failure to comply with these requirements will result in the imposition of sanctions against the non-complying party.

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 25, 1983, in Reno, Nevada.

/s/ John H. Stratton
JOHN H. STRATTON

SUPREME COURT OF THE UNITED STATES

No. 85-554

UNITED STATES, PETITIONER

v.

HUGHES PROPERTIES, INC.

ORDER ALLOWING CERTIORARI

Filed December 2, 1985

The petition herein for a writ of certiorari to the United States Court of Appeals for the Federal Circuit is granted.

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Supreme Court, U.S.
FILED
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JOSEPH F. SPANIOL, JR.
CLERK

No. 85-554

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether a gambling casino using the accrual method of tax accounting is entitled to deduct, as a fixed liability at the close of its taxable year, the amounts registered on the "jackpot indicators" of its progressive slot machines, even though it has no obligation to pay such amounts unless and until the jackpots are won by its patrons in some future year.

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In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-554

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is reported at 760 F.2d 1292. The opinion of the Claims Court (Pet. App. 5a-20a) is reported at 5 Cl. Ct. 641.

JURISDICTION

The judgment of the court of appeals (Pet. App. 4a) was entered on May 2, 1985. On July 11, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including September 29, 1985 (a Sunday). The petition was filed on September 30, 1985, and was granted on December 2, 1985. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 162, 446 and 461 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Section 1.461-1 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out in a statutory appendix (Pet. App. 22a-24a).

STATEMENT

1. The relevant facts were stipulated (Pet. App. 5a). Respondent Hughes Properties, Inc., is a Nevada corporation that owns Harolds Club, a gambling casino in Reno, Nevada. During the tax years at issue, respondent owned and operated "progressive slot machines" in its casino (*id.* at 6a). Like other slot machines, a "progressive" slot machine pays fixed amounts when certain combinations of symbols appear. Unlike other slot machines, however, a "progressive" slot machine also has an additional, "progressive" jackpot. This jackpot is initially set at a minimum amount determined by the casino (*ibid.*). It automatically increases, according to a ratio determined by the casino, as money is gambled on the machine (J.A. 64). The amount of the jackpot outstanding at any given time is registered on a meter, or "payoff indicator," on the face of the machine (Pet. App. 6a-7a & n.2). This sum continues to increase as patrons gamble on the machine until the jackpot is won or until a maximum amount, again determined by the casino, is reached (*id.* at 6a). A progressive jackpot can be won only when a customer gambles the required amount of money and the machine displays the winning combination of symbols (*ibid.*).

The odds of winning a progressive jackpot are a function of the number of reels on the machine, the

number of positions on each reel where the reel may stop, and the number of winning symbols placed on each reel (Pet. App. 6a; J.A. 29). The odds are determined by respondent; provided that there actually exists a possibility that the winning combination of symbols can appear, respondent's discretion in setting odds is unrestricted. By adjusting the odds, respondent can determine, within limitations prescribed by the law of averages, the frequency with which any particular progressive slot machine will pay off. In a 1976 study of 24 representative machines, respondent ascertained that one machine had been in operation for 13 months without a payoff, that another machine had been in operation for 35 months without a payoff, and that the payoff frequency of the other 22 machines ranged from a high of 14.3 months to a low of 1.9 months (Pet. App. 7a n.1).

2. In September 1972 the Nevada Gaming Commission promulgated a rule that, for the first time, regulated the use of progressive slot machines by licensed casinos. Nev. Gaming Reg. § 5.110 (1972) (reprinted at J.A. 55-56). The rule requires gaming establishments to maintain daily records of the progressive jackpot amounts registered on each machine (Nev. Gaming Reg. § 5.110(5) (1972)). It directs that "[n]o payoff indicator shall be turned back to a lesser amount" unless the progressive jackpot is won by a customer, or unless "the change in the indicator reading is necessitated through a machine malfunction" (*id.* § 5.110(2)). In the latter event, a report explaining the reduction in the payoff indicator must be filed (*id.* § 5.110(5)). The rule does not address the consequences of a casino's election to discontinue use of a machine, *e.g.*, by retiring it from service or by removing it from the floor indefinitely. The Gam-

ing Commission's unwritten policy in such circumstances apparently is to require that the casino transfer the amount registered on the jackpot indicator of such a machine to another progressive slot machine remaining in play at the same premises. J.A. 78; see Nev. Gaming Reg. § 5.110(5) (1977) (reprinted at J.A. 56-57).

The Gaming Commission rule described above is strictly enforced by the Commission, which is authorized to impose sanctions (including license revocations) on casinos that wrongfully refuse to pay a progressive jackpot to a winning customer (Pet. App. 9a). The rule applies to all Nevada casinos so long as they remain in the gaming business (J.A. 44). If a casino were to go out of business, to surrender its gaming license, or to enter bankruptcy proceedings, it would no longer be subject to the rule and would be free to reduce or eliminate the amounts shown on its progressive jackpot indicators (*id.* at 23, 44). The rule does not address the treatment of progressive slot machine jackpots in the event of the sale or other disposition of a gaming business. The Gaming Commission's unwritten policy in such circumstances apparently is to require that the buyer continue the machines in play, without reduction of the payoff indicators (*id.* at 20, 38, 43, 59-60, 78). Whether the sales price would be adjusted to reflect that requirement, however, is a matter of negotiation between the buyer and the seller (*id.* at 20, 43, 59, 78).

It is respondent's practice to remove the coins deposited by customers into its progressive slot machines (generally called "the drop") at least twice per week and on the last day of each calendar month (J.A. 68). The Nevada Gaming Commission does not regulate respondent's use of the funds thus collected. The Commission's regulations were amended in 1977 to require that casinos at all times maintain either "a minimum cash reserve" or "sufficient cash or cash equivalents to provide payment of all progressive jackpots offered to the public as prizes" (Nev. Gaming Reg. § 5.110(3) (1977)). But casinos are free to invest such funds as they see fit until the jackpots are actually won by customers.

3. Respondent uses the accrual method of accounting for federal tax purposes. In compliance with the Gaming Commission rule described above, respondent recorded the meter readings shown on its progressive slot machines every day and made no impermissible reductions of the machines' payoff indicators (Pet. App. 9a). At midnight on the last day of its fiscal tax year, respondent entered the jackpot amounts shown on those indicators as an "accrued liability" on its books (*ibid.*). From that total, respondent subtracted the previous year's "accrued jackpot liability" to produce a "net accrued liability" for the tax year in question (*id.* at 10a). On its federal income tax returns for 1973-1977, respondent deducted the latter amounts under Section 162 of the Code[1] as "ordinary and necessary [business] expenses paid or incurred during the taxable year."

The Commissioner on audit disallowed the claimed deductions. He noted that, under the accrual method of tax accounting, an expense may not be deducted until "all of the events have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)). The Commissioner determined that the events which would fix respondent's liability to pay a particular progres-

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the tax years at issue (the Code or I.R.C.).

sive jackpot would be some lucky patron's pull of the handle, and the consequent appearance of the winning symbols on the slot machine, in some future tax year. Until those events occurred, the Commissioner concluded, respondent's obligation to pay the jackpots was contingent and thus gave rise to no deductible expense (Pet. App. 10a). The Commissioner determined a deficiency in respondent's income tax in the amount of $433,000 for the tax years at issue (*id.* at 1a, 21a).

4. Respondent paid the asserted deficiency and, following the denial of its administrative claim for refund, filed this refund suit in the Claims Court. Respondent contended that the year-end amounts shown on the payoff indicators of its progressive slot machines were deductible because there was "a reasonable expectancy that * * * payment [would] be made" at some future date (J.A. 47). Respondent argued that the accrual of such amounts as current liabilities "conform[ed] with generally accepted accounting principles and result[ed] in a proper matching of revenues and expenses" (*id.* at 51). It produced an affidavit from its accountants to that effect (*id.* at 45-46, 69).

On cross motions for summary judgment, the Claims Court ruled for respondent (Pet. App. 4a, 19a). It concluded that, under the Gaming Commission rule described above, respondent's liability to pay the amounts on the progressive jackpot indicators became "unconditionally fixed" (*id.* at 14a) at "midnight of the last day of the fiscal year" (*id.* at 19a). In the Claims Court's view, the last event necessary to fix respondent's liability for the progressive jackpots was "the last play (successful or not) of the machine before the close of the fiscal year, that is,

the last change in the jackpot amount before the amount is recorded for accounting purposes" (*id.* at 13a). "The winning handle pull," the court said, would "only determine[] the fortunate gambler in whose favor the liability [would be] enforced" (*id.* at 14a) (original quotation marks omitted)). The court appeared to acknowledge that if respondent "were to close its doors and go out of business, * * * it would not owe the jackpots to anybody" (*id.* at 15a (original quotation marks omitted)). But "[e]ven if the progressive slot machines were to never pay off," the court reasoned, "the set jackpot amounts indicated on the face of the machine[s] would still continue to be an *incurred* liability fixed by state law" (*id.* at 14a (emphasis in original)). The court said that a contrary result would mismatch respondent's income and expenses and in effect would "convert [respondent] * * * from an accrual basis taxpayer to a cash basis taxpayer" (*id.* at 14a-15a (emphasis omitted)).

The Federal Circuit affirmed "on the basis of the * * * Claims Court opinion" (Pet. App. 3a). It held that a "fixed liability" exists for federal tax purposes "if there is an obligation to perform an act and the cost of performance can be measured in money" (*id.* at 2a). Applying that standard, it agreed with the Claims Court that respondent's progressive-jackpot liability was "unconditionally fixed as of the close of the taxable year" (*ibid.*). The court noted that its holding conflicted with that of the Ninth Circuit in *Nightingale* v. *United States*, 684 F.2d 611 (1982), but it did not further discuss that decision or the reasoning that the Ninth Circuit there advanced.

SUMMARY OF ARGUMENT

The timing of deductions for accrual-basis taxpayers is governed by the "all events" test of tax accounting. That test has two elements, both of which must be satisfied before accrual of an expense is proper. First, "all of the events [must] have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)). Second, "the amount [of the liability must] be determin[able] with reasonable accuracy" (*ibid.*). The question here is whether respondent met the first part of the test, that is, whether it had a "fixed liability" to pay the progressive jackpots as of the close of its tax year.

This Court has consistently held that a liability does not accrue for purposes of the "all events" test as long as it remains contingent. *Brown* v. *Helvering*, 291 U.S. 193, 200 (1934). To be deductible for tax purposes, "the obligation to pay [must] ha[ve] become final and definite." *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 287 (1944). It must be "unconditional." *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930).

Respondent's liability for the progressive slot machine jackpots was plainly not "fixed" or "unconditional" at midnight on the last day of its tax year. At that moment, there existed no person at all who could assert any possible claim to those funds. Rather, respondent's liability to pay each jackpot was contingent upon a future event—some lucky patron's winning pull of the slot machine handle at an indeterminate future time. Until that event happened, "all the events" that were necessary to make respondent's liability fixed and unconditional had not occurred. Respondent quite simply was not liable to anyone until somebody won the jackpot.

Contrary to the court of appeals' statement, the Nevada Gaming Commission rule, which prohibits casinos from turning back the meters on their progressive slot machines, does not alter the conditional nature of respondent's year-end liability. That rule does not require respondent to pay a jackpot unless and until it is won by a customer. The rule thus leaves respondent's year-end liability subject to the same future condition—the winning pull of the handle—to which it was subject before the rule was promulgated. The effect of the rule is simply to place a floor beneath the *amount* of respondent's *potential* liability: it dictates that the dollar amount of respondent's obligation, if and when it is incurred, will be at least a specified sum. But while the Gaming Commission rule might thus be relevant in deciding whether the amount of respondent's liability could "be determined with reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)) for purposes of the *second* part of the "all events" test, that rule makes no difference in deciding whether respondent's liability, for purposes of the first part of the test, is "fixed" and "unconditional" at year's end.

In permitting respondent to take a current tax deduction for a contingent future expense, the court of appeals ignored the import of this Court's decisions emphasizing the critical differences between tax and financial accounting. Because there is a probability that respondent will eventually incur liability for its progressive jackpots, financial accounting rules, implementing "the principle of conservatism" (*Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542 (1979)), may well require respondent to establish a year-end reserve for those items and show them as a liability on its books. But "[o]nly a few

reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts" (*Brown* v. *Helvering*, 291 U.S. at 201-202). Rather, "the tax law requires that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain" (*Thor Power Tool Co.*, 439 U.S. at 543, quoting *United States* v. *Anderson*, 269 U.S. 422, 441 (1926)). By insisting upon certainty of liability rather than probability, the "all events" test serves the objective of tax accounting "to protect the public fisc" (*Thor Power Tool Co.*, 439 U.S. at 542) by ensuring that taxpayers do not obtain current tax deductions for contingent expenditures that may actually occur far in the future, or not at all.

ARGUMENT

THE AMOUNTS SHOWN ON THE JACKPOT INDICATORS OF RESPONDENT'S PROGRESSIVE SLOT MACHINES WERE NOT DEDUCTIBLE AS AN ACCRUED EXPENSE AT THE CLOSE OF ITS TAXABLE YEAR

A. An Expense Is Not Deductible For Federal Tax Purposes Until There Exists A Fixed Liability To Pay It, And Respondent Had No Obligation To Pay The Jackpots Unless And Until Somebody Won Them

1. Section 162(a) of the Internal Revenue Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A taxpayer who uses the "cash receipts and disbursements method" of accounting (I.R.C. § 446(c)(1)) is entitled to deduct business expenses only in the year in which they are paid (Treas. Reg. §§ 1.446-1(c)(1)(i), 1.461-1(a)(1)). A taxpayer who uses the

"accrual method" of accounting (I.R.C. § 446(c)(2)), by contrast, is entitled to deduct expenses in the year in which they are "incurred," regardless of when they are actually paid (I.R.C. § 162(a); Treas. Reg. § 1.461-1(a)(2)). It is well settled that " 'to incur' means to become liable or subject to." *Ox Fibre Brush Co.* v. *Blair*, 32 F.2d 42, 47 (4th Cir. 1929), aff'd *sub nom. Lucas* v. *Ox Fibre Brush Co.*, 281 U.S. 115 (1930). "[A] thing for which there exists no obligation to pay, either express or implied, cannot in law be claimed to constitute an 'expense incurred.' " *United States* v. *St. Paul Mercury Indemnity Co.*, 238 F.2d 594, 598 (8th Cir. 1956).

For almost sixty years, the standard for determining when an item of expense is to be regarded as "incurred" for federal tax purposes has been the "all events" test. That test was first enunciated by this Court in *United States* v. *Anderson*, 269 U.S. 422 (1926), where it was held that an expense is deductible, not for the year in which an obligation attaches "[i]n a technical legal sense," but for the year in which "all the events [have] occur[red] which fix [its] amount * * * and determine the liability of the taxpayer to pay it" (269 U.S. at 441). The "all events" test has subsequently been incorporated in the Treasury Regulations. See Treas. Reg. §§ 1.446-1(c)(1)(ii) (accruals in general), 1.451-1(a) (accrual of income), 1.461-1(a)(2) (accrual of deductions). The Court has described it as "a fundamental principle of tax accounting" and as "the 'touchstone' for determining the year in which an item of deduction accrues." *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 385 (1961).

The "all events" test has two elements, both of which must be satisfied before accrual of an expense

is proper. First, "all the events [must] have occurred which establish the fact of the liability giving rise to [the] deduction" (Treas. Reg. § 1.446-1(c)(1)(ii)). Second, the amount of the deduction must be capable of being "determined with reasonable accuracy" (*ibid.*). The second part of the test permits a degree of computational flexibility. See *Lucas* v. *American Code Co.*, 280 U.S. 445, 450 (1930); Treas. Reg. § 1.461-1(a)(2). But the Regulations emphasize that the first part of the test is absolute: "no accrual shall be made in any case [unless] all of the events have * * * occurred which fix the liability" (*ibid.*).

In determining whether a liability has become "fixed," and thus constitutes an "expense incurred during the taxable year" for federal tax purposes, this Court long ago made clear that "a liability does not accrue as long as it remains contingent." *Brown* v. *Helvering*, 291 U.S. 193, 200 (1934). Accord, *e.g.*, *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, 519 (1944). "The prudent businessman," Justice Brandeis wrote for the Court, "often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas* v. *American Code Co.*, 280 U.S. at 452 (footnote omitted). Accord, *Brown* v. *Helvering*, 291 U.S. at 201-202; *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 269 (1930). To be deductible for federal tax purposes, "the obligation to pay [must] ha[ve] become final and definite." *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 287 (1944). It must be "fixed and absolute." *Brown* v. *Helvering*, 291 U.S. at 201. It must be "unconditional." *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930). "[T]he tax law requires," in short, "that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 543 (1979) (quoting *United States* v. *Anderson*, 269 U.S. at 441).

2. Contrary to the statements of the courts below (Pet. App. 2a, 14a), respondent's liability for the progressive slot machine jackpots was not "fixed and certain," was plainly not "unconditional" or "absolute," at midnight on the last day of its fiscal tax year. At that moment, there existed no person at all who could assert any possible claim to those funds. An expense may not be deducted consistently with this Court's decisions until *all the events* have occurred that *unconditionally establish* the fact of the taxpayer's liability. In the case of a progressive slot machine liability, "[t]he one, indispensable such event is the winning of the progressive jackpot by some fortunate gambler. Until that event occurs, no actual liability has been incurred." *Nightingale* v. *United States*, 684 F.2d at 614. Because "the casino's liability on each slot machine is contingent * * * * * upon a winning pull" of the slot machine handle, that event, as the Ninth Circuit has correctly held, is "most naturally regarded as a condition precedent" to the creation of a fixed obligation (*id.* at 614, 615).

Since the progressive jackpots had not been won at the close of respondent's fiscal year, respondent as of then had incurred no liability, much less a fixed and unconditional liability, to pay those sums to anyone. It was of course likely that respondent would *eventually* incur a liability to pay those amounts, since it was probable (given the law of averages) that some lucky customer would eventually pay his money and hit the winning combination of symbols. But Nevada law places "no restrictions * * * on

gaming establishments for the setting of odds, provided that there is actually a possibility that the winning combination of symbols can appear" (*Nightingale* v. *United States*, 684 F.2d at 612). Respondent thus had discretion, subject to the law of averages, to defer indefinitely into the future the time at which its liability would be incurred. The odds of winning a progressive jackpot at the casino involved in *Nightingale* in fact varied "from one chance in 8,000 to one chance in 9,765,625" (*ibid.*). Nevada law, moreover, places "no restrictions on the transferability of the accrued but unpaid [jackpot amounts] on one progressive slot machine to another progressive slot machine." *Id.* at 613. See J.A. 78; Nev. Gaming Reg. § 5.110(5) (1977). Respondent thus had discretion, again subject to the law of averages, to advance ever further into the future the time at which its liability would be incurred, simply by removing a machine from the floor and transferring the amount shown on its jackpot meter to another machine with a more distant projected payoff date.

Besides being able indefinitely to defer the date of actual liability, respondent also had discretion to avoid incurring any liability at all. "If [a casino] were to close its doors and go out of business," the Ninth Circuit observed in *Nightingale*, "it would not owe the jackpots to anybody," a fact that "tends to show that there is no present liability" (684 F.2d at 615). The record in this case likewise reveals that if respondent were to sell its business, cease its gaming operations, or enter bankruptcy, or if its patrons were to stop playing its slot machines, it would have no liability, and would never have any liability, to pay the jackpots to anyone. See J.A. 20,

23, 43-44, 59, 78. It may well be, as respondent's witness stated below (*id.* at 63), that the possibility of these things happening was "extremely remote and speculative." But the odds of their happening, like the odds of a customer's winning a progressive jackpot, were entirely a matter of respondent's discretion. And there is no reason to believe that the odds against their happening, mathematically speaking, differed appreciably from the odds against a customer's winning the jackpot on a progressive slot machine programmed to pay off (say) at "one chance in 9,765,625" (*Nightingale*, 684 F.2d at 612).

3. In permitting respondent to take a current tax deduction for progressive jackpots that nobody had yet won, the courts below relied principally on the Nevada Gaming Commission's regulations. As we have noted, Section 5.110(2) of those rules, adopted in 1972, provides that "[n]o payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player" (J.A. 55). "Th[is] [C]ommission regulation," the court of appeals said, "makes the guaranteed jackpot a fixed liability" (Pet. App. 2a). The Claims Court similarly reasoned that, "[e]ven if the progressive slot machines were to never pay off, the set jackpot amounts indicated on the face of the machine[s] would still continue to be an incurred liability fixed by state law" (*id.* at 14a (emphasis omitted)).

This reasoning is seriously flawed. The Gaming Commission rule does not require respondent to pay a jackpot unless and until it is won by a customer. The rule thus leaves respondent's year-end liability in essentially the same contingent state that it was in, and leaves it subject to exactly the same condi-

tion (the winning pull of the handle) to which it was subject, before the Gaming Commission began regulating progressive slot machines in 1972. The effect of the rule is simply to place a floor beneath the *amount* of respondent's *potential* liability, while leaving the liability itself contingent. By prohibiting casinos from turning back the jackpot indicators, the rule ensures that those meters at all times will indicate the minimum amount that a future patron will win if he hits the winning combination of symbols. The rule provides that the dollar amount of the jackpot respondent offers can never ratchet down, but must always stay the same or ratchet up; it dictates that respondent's liability, if and when it is incurred, will be in an amount proportional to the number of times the machine has previously been played. But because the rule does not require respondent to pay a jackpot unless and until it is actually won, the rule does not alter the contingent nature of respondent's obligation at the close of its tax year.

Of course, if respondent *did* have a fixed rather than a contingent liability at the close of its tax year, the Gaming Commission rule could well permit respondent to satisfy the *second* part of the "all events" test. Given the existence of that rule, arguably, it would be possible for "the amount [of respondent's liability to] be determined with reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)). Respondent, however, did not have an unconditional liability at that time, and the Gaming Commission rule makes no difference in determining whether this first, and essential, component of the "all events" test has been satisfied.

4. The Claims Court sought to support its result by reasoning that, "were the actual winning handle pull held to be the last event necessary to satisfy the 'all events' test, the effect * * * would be to convert [respondent] from an *accrual* basis taxpayer to a *cash* basis taxpayer" (Pet. App. 14a-15a (emphasis in original)). This argument, which respondent repeats (Br. in Opp. 5, 13), is both factually erroneous and legally irrelevant. The event that converts respondent's offer of a jackpot from a contingent to a fixed liability, and which thus justifies an accrual under the "all events" test, is the winning pull of the slot machine handle. Because the money corresponding to the jackpots will typically be sitting in the casino's bank account rather than in the slot machine (see pages 4-5, *supra*), the customer's winning pull of the handle and his receipt of payment from the casino will not normally be contemporaneous. Once a jackpot has been won, however, the casino may properly claim a deduction, consistently with its accrual method of accounting, regardless of whether it writes its customer a check for his winnings at once or defers payment until the next day or the next year.[2] Respondent's assertion that our position effectively puts it on the cash basis of accounting for progressive jackpots is thus incorrect.

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[2] The sole exception would be where the casino contested its liability. See, *e.g.*, *Dixie Pine Co.* v. *Commissioner*, 320 U.S. at 519 (all the events necessary to fix a taxpayer's liability have not occurred where "the liability is contingent and is contested by the taxpayer"); J.A. 77 (Nevada gaming authorities will dismiss a complaint alleging nonpayment of a progressive jackpot upon determining that "the gaming establishment justifiably refused to pay the progressive jackpot because of cheating by the customer or other valid reasons.").

Even if respondent's assertion were factually correct, however, it would be irrelevant to the outcome. Under the "all events" test, an expense may not be deducted until the taxpayer has incurred a fixed liability to pay it. A taxpayer that elected, for reasons adequate to itself, to incur and to discharge its liabilities simultaneously could not be heard to complain that the "all events" test had the effect of requiring it "to report [those] expenses on the cash method" (Br. in Opp. 13).

5. While the facts of this case may seem exotic, they are a variation on a theme that recurs frequently in tax jurisprudence. It often happens that a taxpayer is under a present obligation—be it statutory, regulatory, or contractual—to make specified future payments upon the happening of specified future events. This Court and the lower courts alike have held that such generalized and incomplete obligations cannot justify current tax deductions under the "all events" test, correctly reasoning that such liabilities remain contingent until the requisite future events have transpired. These decisions show the error of the court of appeals' notion that a deduction is allowable for federal tax purposes, without more, "if there is an obligation to perform an act and the cost of performance can be measured in money" (Pet. App. 2a).

This Court's decision in *Brown* v. *Helvering*, *supra*, is particularly instructive. The taxpayer there was an insurance agent who received "overriding commissions" on the sale of insurance policies (291 U.S. at 195). "As to each such commission there arose the obligation—a contingent liability—to return a proportionate part in case of cancellation" (*id.* at 199). The taxpayer established on his books a reserve ac-

count in which he recorded, at year's end, "an estimate of the liability expected to arise out of [his] obligations to refund [part of the commissions] because of cancellations which it was expected would occur in future years" (*id.* at 197). Based on past experience, the taxpayer was able to predict with reasonable accuracy the percentage of policies that would be cancelled, and thereby to calculate with colorable precision the portion of the commissions that he would ultimately be required to return (*id.* at 197-198, 201 & n.7). The taxpayer sought to deduct, as a business expense "incurred during the taxable year," the amount added annually to this reserve (*id.* at 200).

This Court unanimously sustained (291 U.S. at 200) the Commissioner's disallowance of the claimed deduction:

> It is true that where a liability has "accrued during the taxable year" it may be treated as an expense incurred; and hence as the basis for a deduction, although payment is not presently due, * * * and although the amount of the liability has not been definitely ascertained. *United States* v. *Anderson*, [269 U.S. at 441]. * * * But no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year. Except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent.

The Court acknowledged that there existed "a strong probability," judging from the taxpayer's past experience, that many of the policies written during the year would be cancelled (291 U.S. at 201). "But experience taught also," the Court wrote, "that we are

not dealing here with certainties." Because the taxpayer's "liability * * * arising from expected future cancellations * * * was not fixed and absolute" at the close of his tax year (*ibid.*), the deduction that he sought was denied.

The lower courts have reached similar results in a variety of factual settings. In *Trinity Construction Co.* v. *United States*, 424 F.2d 302 (5th Cir. 1970), an employer had a contractual obligation to pay future premiums on policies insuring the lives of key employees, and it sought a current deduction for the premium payments expected to be made over the contract term. The Fifth Circuit denied a deduction; it noted that the employer's liability was contingent on the employees' being alive when the premiums were due, and it held that an expense may be deducted "only in the taxable year when the obligation to pay it is unconditionally fixed" (424 F.2d at 305). In *Bennett Paper Corp.* v. *Commissioner*, 699 F.2d 450 (8th Cir. 1983), an employer had a contractual obligation to make future payments to a profit-sharing plan on account of employees' past services, provided that the individuals were still employed when the payments were due. The Eighth Circuit denied a current deduction; it noted that "the forfeiture provision made the * * * liability a contingent liability," and it held that a "liability is not fixed until all the conditions for payment are met" (699 F.2d at 453). In *World Airways, Inc.* v. *Commissioner*, 62 T.C. 786 (1974), aff'd, 564 F.2d 886 (9th Cir. 1977), an airline had a contractual obligation to make future payments for statutorily-required engine overhauls, and it sought a current deduction for amounts expected to be paid over the contract term. The Tax Court denied a deduction; it noted that the taxpayer "was

under no obligation to make any payment unless an overhaul was actually performed," and it held that an expense is not deductible unless the taxpayer's liability is "absolutely fixed in the year of accrual" (62 T.C. at 802, 804).

The rationale of these cases shows the error of the holding below. Respondent's obligation was in the nature of the offer of a prize, a prize that might be won if and when some future patron paid his money and plucked the winning combination of stars, bars, and fruit. So long as respondent chose to stay in the gambling business, the Gaming Commission's rule required that this offer be irrevocable. But respondent's *liability* on the offer was nevertheless contingent until a future customer *accepted* the offer by satisfying the preconditions for payment. One does not have an "unconditional liability" unless there exists some person or entity to whom he is liable, and respondent was not liable to anyone until somebody won the jackpot.

B. In Permitting Respondent To Take A Current Tax Deduction For A Contingent Future Expense, The Court Of Appeals Misapprehended The Differences That This Court Has Recognized Between Tax And Financial Accounting

Following the promulgation of the Gaming Commission's rule in 1972, respondent's accountants determined that there thenceforth existed a sufficient likelihood that respondent's jackpots would be paid to require that the year-end amounts shown on its payoff indicators "be reported on the financial records of the corporation as accrued liabilities" (J.A. 68, 69). The accountants explained that this treatment was required in order properly to match respondent's expenses with its income. "Because the amount of the

liability for accrued but unpaid * * * jackpots increases in direct proportion to the volume of play on the machines, and because the income is recorded during the same period in which the play occurs * * *, the recordation of the increase in the accrued but unpaid * * * jackpots as a reduction of the slot machine gross profit in the same period results in a proper matching of revenues and expenses and clearly reflects income" (*id.* at 68). The accountants testified that this treatment "conform[ed] with generally accepted accounting principles" and that any other treatment "could result in a material distortion of [respondent's] income" (*id.* at 69).

The court of appeals appeared to find these statements persuasive in permitting a corresponding deduction for tax purposes. It reasoned that "the accounting method used by [respondent] results in allocation of the expense to the year in which the revenues were earned," and so concluded that respondent's "method of accounting accurately reflects the casino's income and expenses" (Pet. App. 2a-3a). "If we were to require that the deduction of a jackpot liability be deferred" until the jackpot was actually won, the court of appeals said, it would mismatch respondent's revenue and expenses and thus "distort taxable income for the year of payment" (*id.* at 2a).

In thus reasoning, the Federal Circuit ignored the import of this Court's decisions emphasizing the critical differences between tax and financial accounting. The court of appeals' misapplication of the "all events" test seems largely traceable to its neglect of this distinction, a distinction that is crucial to a proper understanding of the role that the "all events" test plays in the tax law.

1. Taxable income is generally computed "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books" (I.R.C. § 446(a)). Section 446(b), however, sets forth an exception to this rule, providing that, if the method of accounting used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." The Regulations provide that "[t]he term 'method of accounting' includes not only the overall method of accounting of the taxpayer," such as the cash method or the accrual method, "but also the accounting treatment of any item." Treas. Reg. § 1.446-1(a)(1). The Regulations categorically state that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." Treas. Reg. § 1.446-1(a)(2).

Section 446 and its accompanying regulations obviously vest the Commissioner with "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959). This Court early noted that the general rule permitting use of the taxpayer's usual accounting practice "is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income." *Lucas* v. *American Code Co.*, 280 U.S. at 449. And the Court recently reaffirmed that the Commissioner in the accounting area has " '[m]uch latitude for discretion' " and that "his interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.' " *Thor Power Tool Co.*, 439 U.S. at 532 (quoting *Lucas* v. *American Code Co.*, 280 U.S. at 449). Accord, *e.g.*, *United States* v.

Catto, 384 U.S. 102, 114 (1966); *Schlude* v. *Commissioner*, 372 U.S. 128, 133-134 (1963); *American Automobile Ass'n* v. *United States*, 367 U.S. 687, 697-698 (1961); *Automobile Club* v. *Commissioner*, 353 U.S. 180, 189-190 (1957); *Brown* v. *Helvering*, 291 U.S. at 203.

Congress's decision to grant the Commissioner "broad powers" to depart from the taxpayer's usual accounting practice in computing taxable income owes in part to "the vastly different objectives that financial and tax accounting have." *Thor Power Tool Co.*, 439 U.S. at 542. "The primary goal of financial accounting is to provide useful information to management, shareholders, [and] creditors" and "to protect these parties from being misled" (*ibid.*). Financial accounting accordingly "has as its foundation the principle of conservatism, with its corollary that possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income" (*ibid.*; original quotation marks omitted). "[T]he major responsibility of the Internal Revenue Service," by contrast, "is to protect the public fisc," so that "understatement of income is not destined to be its guiding light" (*ibid.*). Given this diversity, even contrariety, of objectives, to say that a taxpayer's accounting practice " 'is in accord with generally accepted commercial accounting principles' * * * is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." *American Automobile Ass'n* v. *United States*, 367 U.S. at 693 (footnote omitted).

This Court's cases demonstrate that divergence between tax and financial accounting is especially common where, as here, "a taxpayer seeks a current deduction for estimated future expenses or losses"

(*Thor Power Tool Co.*, 439 U.S. at 541). Financial accounting rules, implementing the principle of conservatism, "typically require that a liability be accrued as soon as it can reasonably be estimated" (*id.* at 543 & n.20 (citing authorities)). Accruals of such anticipated liabilities are commonly made by establishing on the corporation's books a reserve account to cover amounts reasonably expected to be paid in the future. See, *e.g.*, *Commissioner* v. *Hansen*, 360 U.S. at 448 (reserve to cover contingent liability in event of nonperformance of guarantee); *Brown* v. *Helvering*, 291 U.S. at 196-197 (reserve to cover expected liability in event of insurance policy cancellations); *Lucas* v. *American Code Co.*, 280 U.S. at 447 (reserve to cover contingent liability on contested lawsuit).

But while "[t]he prudent businessman often sets up reserves to cover contingent liabilities[,] * * * they are not allowable as deductions" (*Lucas* v. *American Code Co.*, 280 U.S. at 452). Rather, "the tax law requires that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain" (*Thor Power Tool Co.*, 439 U.S. at 543 (quoting *United States* v. *Anderson*, 269 U.S. at 441)). "[T]he 'all events' test * * * is designed to assure that taxpayers will not obtain deductions for expenditures that might never occur," and it thus "seeks certainty of liability rather than probability" (*World Airways, Inc.*, 62 T.C. at 805 (citing *Brown* v. *Helvering*, 291 U.S. at 201)). By insisting upon certainty of liability, the "all events" test helps guarantee that taxable income will be computed in a manner that "clearly reflect[s] income" (I.R.C. § 446(b)), for "[i]t has long been held that in order truly to reflect the income of a given year, all the events must

occur in that year which fix the amount and the fact of the taxpayer's liability" (*Dixie Pine Co.* v. *Commissioner*, 320 U.S. at 519).

2. The court of appeals departed from these well-established principles in sustaining respondent's deduction. It may well be, as respondent contended below, that the year-end accrual of its contingent slot machine liabilities "conform[ed] with generally accepted accounting principles" (J.A. 69) because there was "a reasonable expectancy that * * * payment [would] be made" (*id.* at 47). There was surely a probability, gambling being what it is, that respondent would eventually incur liability for its progressive slot machine jackpots. Although the timing of that liability's incurrence was subject to respondent's discretion in setting odds, there was also a mathematical possibility that it might be incurred the very next day. Thus, "the principle of conservatism" (*Thor Powe. Tool Co.*, 439 U.S. at 542) may well have required respondent to set up a reserve for those items at once and show them as a liability on its books. "[B]ut the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes" (*id.* at 543). Although "estimates, probabilities, and reasonable certainties * * * may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health," the tax law, "with its mandate to preserve the revenue, can give no quarter to uncertainty" (*ibid.*). "Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts." *Brown* v. *Helvering*, 291 U.S. at 201-202 (quoted in *Thor Power Tool Co.*, 439 U.S. at

543-544). A reserve for contingent slot machine liabilities is not among those so authorized.[3]

Contrary to the court of appeals' statement, therefore, the fact that respondent's method of accounting arguably "results in allocation of the expense to the year in which the revenues were earned" (Pet. App. 3a) does not control the outcome here. In *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961), this Court held that "a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenues in contravention of 'generally accepted commercial accounting principles'" (*Thor Power Tool Co.*, 439 U.S. at 541 (quoting *American Automobile Ass'n*, 367 U.S. at 690)). The Court acknowledged that the taxpayer's accounting method, by taking prepaid dues into income ratably over the future years during which it would render the paid-for services, "doubtless presents a rather accurate image of the total financial structure" (367 U.S. at 692). Put the Court nonetheless held that the taxpayer's reserve method "fail[ed] to respect the criteria of annual tax accounting and [could] be rejected by the Commissioner" (*ibid.*).

The same reasoning applies in the present case. By establishing a reserve for its progressive jackpot liabilities, and by making additions to that reserve ratably with its realization of slot machine income, respondent may well have produced an accurate matching of its revenues and expenses for purposes of financial accounting. But that fact provides no

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[3] Cf. I.R.C. § 166(c) (authorizing bad debt reserves in general); I.R.C. §§ 585, 586, 593 (authorizing bad debt reserves for banks and S & L associations); I.R.C. § 807 (authorizing specialized reserves for life insurance companies).

basis for permitting respondent currently to deduct those contingent liabilities on its federal tax return.

3. As this Court noted in *American Automobile Ass'n*, 367 U.S. at 694-697, Congress once adopted, albeit only briefly, provisions that would have permitted taxpayers to deduct anticipated expenses by a reserve mechanism similar to that used by respondent. As originally enacted in 1954, Section 462 of the Code allowed a deduction for "a reasonable addition to [a] reserve for estimated expenses," with "estimated expenses" being defined to include deductions "attributable to the income of the taxable year or prior taxable years." Internal Revenue Code of 1954, § 462(a) and (d)(1)(B), 68A Stat. 158-159. Section 452 as originally enacted similarly permitted accrual-basis taxpayers to defer recognition of prepaid income until later years in which the income was deemed "earned." *Id.* § 452(a), 68A Stat. 152. Congress was moved to enact these provisions by dissatisfaction with the fact that, "as a result of court decisions and rulings, there ha[d] developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles." H.R. Rep. 1337, 83d Cong., 2d Sess. 48 (1954). See *American Automobile Ass'n*, 367 U.S. at 694. Sections 452 and 462 were designed to bring "[t]ax accounting * * * more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." S. Rep. 372, 84th Cong., 1st Sess. 3 (1955). See *American Automobile Ass'n*, 367 U.S. at 703-704 (Stewart, J., dissenting).

The change brought about by Sections 452 and 462 was short-lived. Congress repealed those provisions retroactively less than one year later, prompted by warnings from the Treasury Department "that the proposed endorsement of such [methods of] accounting would have a disastrous impact on the Government's revenue." *American Automobile Ass'n*, 367 U.S. at 695. See Act of June 15, 1955, ch. 143, §§ 1, 3, 69 Stat. 134-135 (repealing 26 U.S.C. (1952 ed. & Supp. II 1954) 452, 462); H.R. Rep. 293, 84th Cong., 1st Sess. 3 (1955) (noting increase in the Treasury's projection of estimated revenue loss from $47 million to $1 billion). The taxpayer in *American Automobile Ass'n* contended that Congress's retroactive repeal of these provisions should not be interpreted to preclude use of the reserve method of tax accounting that it employed, but the Court held that this contention "'varnish[ed] nonsense with the charm of sound'" (367 U.S. at 695). "[T]he cold fact," the Court said, "is that [Congress] repealed the only law incontestably permitting the practice upon which the [taxpayer] depends" (*ibid.*).

Congress thus has specifically considered and, upon reconsideration, rescinded a provision that would have achieved the very result that the court of appeals here adopted. By discarding the "all events" test, the now-repealed Section 462 was designed to bring tax accounting into line with "generally accepted accounting principles which require all determinable liabilities relating to reported income to be taken into account" (S. Rep. 1622, 83d Cong., 2d Sess. 63 (1954)). The court of appeals had no license, by misapplying the "all events" test, to resurrect the rule that Congress deliberately discarded.[4]

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[4] Congress more recently has amended the Code to clarify the requirements for accrual of certain deductions, providing that

4. In sustaining respondent's claimed deductions, the court of appeals also ignored this Court's warning about "the well-known potential for tax avoidance" (*Thor Power Tool Co.*, 439 U.S. at 538) in-

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expenses generally may not be accrued until "economic performance" has occurred. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601 (adding I.R.C. § 461(h) and (i)). Congress set forth for the first time a statutory definition of the "all events" test, providing that "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy" (I.R.C. § 461(h)(4)). This definition, of course, is the same as that previously enunciated by this Court and by the Treasury Regulations. See page 12, *supra*. The 1984 Act generally provides that, "in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs" (I.R.C. § 461(h)(1)). Where the taxpayer's liability arises from the provision of goods or services, or from the use of property, "economic performance" is generally deemed to occur when the goods or services are actually provided, or when the property is actually used (I.R.C. § 461(h)(2)(A) and (B)). Where the taxpayer's liability arises from a worker's compensation statute or tort, "economic performance" is deemed to occur when payments to the recipient are actually made (I.R.C. § 461(h)(2)(C)). An exception from the general rule is made for "certain recurring items" (I.R.C. § 461(h)(3)). Such items may be deducted in the year preceding economic performance, provided that the "all events" test is otherwise satisfied, that economic performance actually occurs within a "reasonable period" (typically, 8½ months) after the close of the tax year, and that such accrual is consistent with financial accounting practices (I.R.C. § 461(h)(3)(A) and (B)). These provisions, which are generally effective for post-1983 tax years (Pub. L. No. 98-369, § 91(g), 98 Stat. 608), have no application to the instant case, which involves respondent's tax liabilities for 1973-1977.

herent in accounting techniques of the sort involved here. Respondent is unquestionably entitled to deduct its progressive slot machine liabilities if and when the jackpots are won by its customers. The dispute here, as in "all events" cases generally, concerns the proper *timing* of deductions, not the intrinsic propriety of the deductions themselves. But to suggest, as respondent seems to do (Br. in Opp. 4, 11-12), that this consideration diminishes the importance of the dispute is to ignore the time value of money. A deduction today is worth more than a deduction one, five, or twenty years from now. If the accruals involved are sufficiently large, their time value alone, as this case demonstrates (Pet. App. 1a, 21a), can involve huge amounts of revenue.

When respondent's customers gamble unsuccessfully on its progressive slot machines, the monies lost represent income that is subject at once to respondent's use and enjoyment. Although respondent will in all probability be required ultimately to return a portion of those funds as jackpots to its customers, it is free to invest the money, and to earn additional income upon it, until the jackpots are actually won. The time at which the jackpots will actually be won, and how large they will be at that time, are essentially within respondent's control. It has discretion to determine when a machine will be placed in service, what the initial jackpot will be, and by what rate that amount will progress. Given its virtually unrestricted discretion in setting odds, respondent has the capacity, subject to the law of averages, to determine each machine's expected payoff date. And given its ability to transfer jackpot amounts from one machine to another, respondent has the capacity, again subject to the law of averages, to defer indefi-

nitely into the future the time at which its duty to make payment to its customers will arise.

Under these circumstances, the method of accounting that respondent favors unquestionably contains the "potential for tax avoidance" (*Thor Power Tool Co.*, 439 U.S. at 538). As the Ninth Circuit pointed out in *Nightingale*, acceptance of respondent's accounting treatment for progressive jackpots would permit casinos "to overcome the restraints of annual accounting in a perfectly legal way. They could put extra machines on the floor on the last day of the tax year with whatever initial jackpot they chose and with whatever odds they liked. Then they could take a current deduction for the full amount even though payment of the jackpots might not occur for many years" (684 F.2d at 615). There is of course no suggestion that this happened here, and it is possible that the Commissioner would have adequate tools with which to respond if it had. See Pet. App. 16a-17a; *Nightingale*, 684 F.2d at 615. But the inherent manipulability of respondent's accounting practice demonstrates its inappropriateness "in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax" (*Thor Power Tool Co.*, 439 U.S. at 544). "If management's election among [such] options were dispositive for tax purposes, a firm * * * could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay" for a particular year. "Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable." *Ibid.*

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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NO. 85-554

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPERTIES, INC.,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR RESPONDENT HUGHES PROPERTIES, INC.

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QUESTION PRESENTED

Whether the Federal Circuit correctly determined the proper time for deduction by an accrual basis taxpayer engaged in the business of gaming of an expense represented by its unpaid liability for progressive slot machine jackpots.

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR RESPONDENT HUGHES PROPERTIES, INC.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved in this case that are not set forth in the statutory appendix to the Petition for Certiorari are Section 1.446-1(c)(1)(ii) of the Treasury Regulations on Income Tax (26 C.F.R.), Section 463.310 of the Nevada Revised Statutes and Section 5.110 of the Nevada Gaming Regulations. These provisions are included in the appendix to Respondent's Brief in Opposition to Petition for Writ of Certiorari (Resp.

App. 1a-5a). Section 463.310 of the Nevada Revised Statutes and Section 5.110 of the Nevada Gaming Regulations are reprinted at J. A. 53-57.

STATEMENT OF THE CASE

This statement of the case is necessitated by deficiences in that of the United States (the "government"). Additional matters which were relevant to the courts below and which respondent, Hughes Properties, Inc. ("HPI"), believes must be considered by the Court are:

1. During the taxable years in issue, HPI owned and operated various types of slot machines which paid progressive, or "guaranteed," jackpots. These machines had different features which bore on the frequency of their payment of guaranteed jackpots (Pet. App. 6a-7a). Guaranteed jackpots are determined at random and not by a predetermined number of plays (Pet. Br. 26). The average period between HPI's payoffs on its progressive slot machines' guaranteed jackpots was approximately 4½ months (Pet. App. 6a-7a; Pet. Br. 26). All of HPI's accrued but unpaid guaranteed jackpots as of the close of the last taxable year in issue, June 30, 1977, were subsequently won by and paid to customers of HPI (J. A. 62).

2. The Nevada Gaming Commission (the "Commission"), which promulgated § 5.110 of the Nevada Gaming Regulations ("Regulations"), and the Nevada Gaming Control Board (the "Board") strictly enforce Regulation § 5.110 and the policies implementing such Regulation. Section 463.310 of the Nevada Revised Statutes ("N.R.S.") authorizes the Commission to impose severe sanctions (including revocation or suspension of gaming licenses and fines up to $100,000) on any licensed gaming establishment that wrongfully refuses to pay a

winning customer a guaranteed jackpot. A guaranteed jackpot cannot be reduced or eliminated except by the winning of such jackpot (Pet. App. 9a).

3. For its taxable years ending June 30, 1973, through June 30, 1977, the gross operating income of HPI's casino, Harolds Club, from its gaming transactions, after deducting all amounts won by customers in gaming transactions, but prior to the deduction of the accrued progressive slot machine liability, and the net income of HPI from all of its activities, after deducting all expenses except the guaranteed jackpot liabilities in issue, were as follows:

Taxable Years Ending June 30	Gross Operating Income From Gaming	Net Income From All Activities
1973	$20,367,609	$4,836,429
1974	20,859,135	5,512,863
1975	21,133,604	4,616,157
1976	23,299,066	6,001,156
1977	23,571,332	5,896,078

(J. A. 35-36).

4. The meter readings on HPI's progressive slot machines provided it the numerical data for the deductions in issue. The accrued but unpaid guaranteed jackpot amounts as recorded by HPI from 1973 to 1977 were:

Fiscal Year Ended June 30	Accrued Liability	Deduction (Income)
1973	$360,228.55	$360,228.55
1974	563,983.99	203,755.44
1975	853,584.22	289,600,23
1976	839,400.97	(14,183.25)
1977	888,820.67	49,419.70

(Pet. App. 9a).

5. HPI deducted as an ordinary and necessary business expense under Section 162 of the Code[1] the net accrued liability for guaranteed jackpots for each fiscal year. Such net accrued liability was determined by subtracting the previous year's accrued liability, which had already been deducted, from the current gross liability as indicated by the meter totals. For example, at midnight on the last day of fiscal year 1974, HPI recorded the meter readings on its progressive slot machines, its accountants totalled the amounts so recorded and determined that HPI's gross year-end liability for that fiscal year was $563,983.99. Because HPI had already deducted $360,228.55 as a business expense in the previous fiscal year, the net accrued liability for 1974 was determined to be $203,755.44. This is the amount that HPI reported as a deduction on its income tax return for fiscal year 1974 (Pet. App. 10a).

6. Although there is no dispute as to the accuracy of the amounts deducted by HPI, the Internal Revenue Service claimed that the guaranteed jackpot payoffs could only be deducted in the year actually paid because the guaranteed jackpot amounts were merely a contingent liability and determined an aggregate deficiency in HPI's income tax, which it paid and for which it sought a refund, in the amount of $433,441.88 for its four taxable years in issue (Pet. App. 1a, 10a).

7. HPI's primary contention to the Claims Court was that the accrued expense deductions were timely because the liability for the guaranteed jackpots was fixed by Nevada law (Pet. App. 12a). The case was decided in the Claims

1. Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the tax years at issue (the "Code").

Court on cross motions for summary judgment. The only evidence offered by the government in support of its motion for summary judgment was an affidavit from its counsel adopting and stipulating factual contentions contained in HPI's pretrial submission (J. A. 15-46) (Pet. Br. 2). Among these stipulated facts was the fact that the guaranteed jackpots constituted a fixed liability for which payment could not be avoided because of Gaming Regulation § 5.110. (J. A. 15-16, 42). The Claims Court stated in its opinion that "[The government] specifically rejects [HPI's] argument that the jackpot liability was fixed *despite admitting that [HPI] is precluded from avoiding payment as a result of Nevada Gaming Commission Regulation § 5.110.*" (Pet. App. 12a) (emphasis added). The Claims Court, in sustaining HPI's position, noted that the government "does not contest the deductibility per se of [HPI's] liability for the guaranteed jackpot amounts, but rather takes issue with the timing of those deductions." (Pet. App. 11a) (original quotation marks omitted). The Claims Court held:

> [A]t the end of [HPI's] fiscal year, [HPI's] obligation to pay out the recorded amount is "unconditionally fixed" by the terms of § 5.110. Under that regulation, the liability for the jackpot amount can be enforced by the Nevada Gaming Commission. . . . That the identity of that "fortunate gambler" is unknown, that the exact time the jackpot will be won is unknown, or that the exact amount of the jackpot at the time it is won is unknown does not affect the certainty of the liability at the end of [HPI's] fiscal year. . . . In the fact setting before the court, the uncertainties listed above do not destroy the initial certainty of liability.

(Pet. App. 14a).

The Claims Court acknowledged that it "will not hesitate to uphold the Commissioner's efforts to eradicate fraudulent practices, but, where no such practice has been alleged or proven and where the court has found that the timing of the deduction does not distort income, the court will not act on mere speculation." (Pet. App. 17a). The Claims Court held that "the liability is *unconditionally fixed* by § 463.310 of the Nevada Revised Statutes which gives full force and effect to Nevada Gaming Regulation § 5.110." (Pet. App. 18a-19a) (emphasis in original). The court "respectfully declined to follow" the Ninth Circuit's contrary decision in *Nightingale v. United States*, 684 F.2d 611 (9th Cir. 1982) (Pet. App. 15a). The Claims Court observed that the Ninth Circuit in *Nightingale* misstated the consequences of a casino's going out of business, noting that from a federal income tax perspective, such event would result in the casino having to recapture its previous deductions as income. (Pet. App. 15a).

8. The Federal Circuit concluded that the trial judge had "carefully examined all of the arguments raised on the present appeal." (Pet. App. 3a). The Court of Appeals "re-examined those arguments, the briefs, statutes, regulations, and authorities and conclude[d] that the [Claims Court] was legally correct when it granted summary judgment to the taxpayer." (Pet. App. 3a). The Federal Circuit acknowledged that the Claims Court had "declined to follow the contrary conclusion of the Ninth Circuit" in *Nightingale* (Pet. App. 2a).

SUMMARY OF ARGUMENT

There is no disagreement that progressive slot machine jackpots are ordinary and necessary business expenses and are deductible under Section 162. The issue before the Court, one which is fundamental to federal income

tax accounting, is the proper *time* for the allowance of such deductions by a taxpayer which has adopted the accrual method of accounting. Determinative of this question is the application of the so called "all events" test, which was first articulated in *United States v. Anderson*, 269 U.S. 422 (1926), and subsequently incorporated in Treasury Regulation § 1.461-1(a)(2). That test dictates that an expense is incurred, and thus properly accrues, for federal income tax purposes *at the time* when the *events* establishing the *fact of liability* for the expense have occurred. Again, there seems to be no disagreement between the government and HPI that it is the application of this principle which governs the disposition of this case. The difference of opinion between the government and HPI, which this Court has been petitioned by the government to resolve, relates to the event which establishes HPI's liability for its guaranteed jackpots and thus the timing of its deduction therefor.

HPI contends, and the Federal Circuit and the Claims Court concur, that the fact of liability for the guaranteed jackpots resulted from HPI's operation of progressive slot machines on its casino floor. Because HPI's obligation to pay the amount of guaranteed jackpots registered on such machines' payoff indicators is unconditionally fixed under applicable Nevada law once such machines are placed in operation, and cannot thereafter be effectively avoided, HPI's accrual of deductions for such liabilities, based on the amounts registered on the payoff indicators at its year end, was proper under federal income tax accounting principles. The government contends that such obligations may be properly accrued only at the time the guaranteed jackpot is won. The position of HPI, the Claims Court, and the Federal Circuit are strongly supported by an extensive body of judicial authority. The government has no support in fact or in law for its position.

ARGUMENT

THE CLAIMS COURT AND THE FEDERAL CIRCUIT CORRECTLY DETERMINED THAT AN ACCRUAL BASIS TAXPAYER ENGAGED IN THE BUSINESS OF GAMING PROPERLY DEDUCTED FOR FEDERAL INCOME TAX PURPOSES ITS ACCRUED LIABILITY FOR GUARANTEED JACKPOTS.

A. Nevada Law Fixes HPI's Liability.

The obligation to pay guaranteed jackpots is established at the time progressive slot machines are placed in operation and at all times thereafter by the Regulations promulgated pursuant to Nevada statutory authority and the policies implementing such Regulations. The Regulations, as implemented by the policies of the Commission and the Board, are binding on all licensed gaming establishments in the State of Nevada. Under Nevada law, the Commission regulates the activities of licensed gaming establishments through its Regulations and policies, and the Board has the authority to enforce these Regulations and policies. A paramount purpose of such Regulations and policies is to protect the interests of the gaming public and to preserve the integrity of the gaming industry in Nevada. N.R.S. §§ 463.140 & 463.0129 (1955).

In September 1972, pursuant to N.R.S. §§ 463 and 463B, the Commission promulgated Regulation § 5.110 which regulates the operators of progressive slot machines. Regulation § 5.110 was effective for all times relevant to the taxable years in issue in this case. Such Regulation precludes a licensed gaming establishment from avoiding payment of its liability for guaranteed jackpots. Under the Regulation, the amount of the liability may not be reduced until the guaranteed jackpot is paid. To insure

payment, licensees are required to maintain minimum cash balances equal to the total of all guaranteed jackpots offered by its machines. Consequently, the Regulation makes the liability for guaranteed jackpots fixed and unconditional from the time a machine is introduced on the casino floor and at all times thereafter.

The undisputed facts establish that the liability for guaranteed jackpots cannot be avoided. Regulation § 5.110 expressly mandates that the payoff indicator for the machines cannot be turned back. The removal of a progressive slot machine from the casino floor, the repair and maintenance of a machine, the conversion of the licensee's form of business organization, or the sale or other disposition of the licensee's business will not result in the licensee being directly or indirectly relieved of its obligation (J. A. 59, 63-64, 73-75, 78). Severe sanctions are applicable to licensees (including fines, but more importantly, revocation or suspension of its license to do business) for attempting to avoid payment of a guaranteed jackpot, or otherwise violating the Commission's Regulations and the policies of the Commission and the Board (N.R.S. § 463.310; J. A. 59, 71-72, 77). It is these Regulations, statutes, and policies which *unconditionally* fixed HPI's liability for the guaranteed jackpots prior to their being won by a customer. It is this liability which required HPI to accrue the liability at year end for federal income tax purposes. HPI had no discretion in the matter. It could not have deferred the deductions even if it had chosen to do so. For example, if HPI anticipated significant income in the succeeding year which the deductions would reduce, it could not have properly deferred the deductions to that year.

Although HPI's machines are mechanically capable of being set at odds which might theoretically suggest that

the chances of a jackpot being won are remote, the average time of payment of HPI's guaranteed jackpots was determined to be approximately 4½ months (Pet. App. 6a-7a). Such statistic is a reflection of the competitive pressures which demand that realistic payoff opportunities be offered to the gaming public and the random occurrence of winning combinations of symbols resulting in jackpots. The determination was made as of September 1, 1976, for the twenty-four (24) four-reel progressive slot machines then in operation. All but two of these machines were installed prior to 1974 (J. A. 62). Although HPI also operated a number of three-reel machines during this period, its payoff experience with respect to these machines was not taken into account in such determination. Because of the fewer number of reels, these machines produce more frequent jackpots than their four-reel counterparts (J. A. 62). All of the accrued but unpaid jackpots utilized by HPI to determine its deductions for the years in issue were actually won by and paid to customers of HPI (J. A. 62).

Anderson, 269 U.S. 422, is the source of the principle that an intervening requirement which serves as a predicate to *fixing the time of payment* of a liability (rather than fixing the liability) does not postpone its accrual for federal income tax purposes. In *Anderson,* the issue was the propriety of the accrual of a munitions tax prior to its assessment. Although such assessment was required before the tax became due, the absence of the assessment did not prevent accrual of the tax.[2] Likewise, in *Continental Tie & Lumber Co. v. United States,* 286 U.S. 290, 295-98 (1932), accrual of a yet-to-be made award

2. It is noteworthy that the government's position in *Anderson,* that the tax liability accrued before assessment, is diametrically opposed to its position in this case.

in an undetermined amount under a newly enacted statute was held proper.

These authorities do not stand alone. Numerous other cases have adopted the principle that the absence of a future event required as a condition to payment of a liability does not render the liability contingent and thus not properly accruable for federal income tax purposes, *e.g., American National Co. v. United States,* 274 U.S. 99 (1927); *Kaiser Steel Corp. v. United States,* 717 F.2d 1304 (9th Cir. 1983); *Crescent Wharf & Warehouse Co. v. Commissioner,* 518 F.2d 772 (9th Cir. 1975), *rev'g* 59 T.C. 751 (1973); *Pacific Grape Products Co. v. Commissioner,* 219 F.2d 862 (9th Cir. 1955), *rev'g* 17 T.C. 1097 (1952). Accordingly, under the well founded principles of *Anderson,* the fact that the "winning handle pull determining the fortunate gambler" to whom a guaranteed jackpot would be paid had not occurred at the end of HPI's taxable year does not preclude HPI from taking such liability into account in determining its taxable income for such year but, to the contrary, requires that it do so.

B. The Federal Circuit's Decision Is Strongly Supported By Analogous Authorities.

The most analogous authorities determining the treatment of guaranteed jackpots as accrued liabilities under the all events test are a series of cases involving strip mining operations. In those cases, the cost of satisfying an obligation imposed by state law has been held properly accruable upon the happening of the events giving rise to such obligation, not when the event fixing the time of performance of such obligation occurs. *Harrold v. Commissioner,* 192 F.2d 1002 (4th Cir. 1951). *See also Denise Coal Co. v. Commissioner,* 271 F.2d 930 (3d Cir. 1959);

Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981).

These cases address the question of whether the estimated costs of restoring stripped land to its former condition may be properly accrued at the time mining occurs or at some then undetermined future date when the costs to restore the land are incurred. These cases hold that it is proper to accrue the restoration expenses at the time the mining occurs despite, as is the case here, there being no specifically identifiable obligee to whom the costs are owed at the time and the time when such costs would be paid being uncertain.

The rationale of the strip mining cases has been followed in other contexts. *Gillis v. United States*, 402 F.2d 501 (5th Cir. 1968) (obligation for anticipated claims resulting from shipping defective cotton); *Schuessler v. Commissioner*, 230 F.2d 722 (5th Cir. 1956) (obligation to turn furnaces on and off at undetermined times); *Pacific Grape Products Co.*, 219 F.2d 862 (future obligation to package and ship products previously sold).

The reason the mining cases and their progeny are so closely analogous to the situation at hand is readily apparent when those cases are compared to this case:

	Mining Cases	*HPI's Case*
Nature of obligation:	Imposed by state law	Imposed by state law
Event establishing fact of liability:	Conducting mining operations	Operating the progressive slot machines
Event establishing time of payment and identity of specific payee:	Contractor's performing backfilling	Customer's winning the guaranteed jackpot

Here, as in the mining cases, the accruals are properly allowable in the taxable years in which the deductions were taken because all events resulting in the liabilities giving rise to the deductions had occurred in those years even though the identity of the payee of such liabilities and the time of payment had not then been determined.

The purpose of the all events test is to insure that no deduction is accrued which will not ultimately be borne in an economic sense. It is clear that accrual of the guaranteed jackpots is entirely consistent with this purpose. Any other conclusion would conflict with a long established body of law.

C. The Government's Position Is Devoid Of Support.

1. The government, in its zeal to enhance the fisc, urges on the Court a result which defers accrual of a clearly allowable expense until the event occurs that requires that the liability giving rise to such expense be satisfied—"a winning pull of the slot machine handle"—not when the fact of liability has been determined (Pet. Br. 13). In support of such result, the government contends that because Gaming Regulation § 5.110 does not expressly require HPI to pay a guaranteed jackpot unless and until it is won, that Regulation creates only what the government sometimes refers to as a "potential" liability and sometimes as a "contingent" liability, neither of which supports the accrual of an expense (Pet. Br. 15-16). The government contends this must necessarily be so because to hold otherwise would ignore the impact of this Court's decision in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), or lead to abusive situations for which no remedy might otherwise exist (Pet. Br. 24-28, 30-32).

The government, in its analysis of Regulation § 5.110, ignores the Commission's underlying policies and, in particular, N.R.S. § 463.310 which subjects HPI to extreme sanctions if it fails to pay a winning gambler. The result it seeks is in direct conflict with a long-standing body of existing law. *Anderson*, 269 U.S. 422; *Denise Coal Co.*, 271 F.2d 930; *Pacific Grape Products Co.*, 219 F.2d 862; *Harrold*, 192 F.2d 1002; *Ohio River Collieries Co.*, 77 T.C. 1369.

The government's principal argument—that no accrual is proper in this case until "the winning of the progressive jackpot by some fortunate gambler"—is based on the Ninth Circuit's analysis in *Nightingale* (Pet. Br. 13). The court in *Nightingale* erroneously concluded that because the time of payment and the identity of the winning gambler were uncertain that the liability in that case for guaranteed jackpots was contingent. *Nightingale*, 684 F.2d at 614. What neither the court in *Nightingale* nor the government here recognizes is that such an analysis ignores, and is in conflict with, well-settled case law which holds that the uncertainty of the time for payment of a liability or the inability to identify the payee of such liability will not prevent the accrual of the underlying expense represented by such liability. *Lukens Steel Co. v. Commissioner*, 442 F.2d 1131 (3d Cir. 1971), *aff'g* 52 T.C. 764 (1969); *Denise Coal Co.* 271 F.2d 930; *Harrold*, 192 F.2d 1002; *Cyclops Corp. v. United States*, 408 F. Supp. 1287 (W.D. Pa. 1976); *Inland Steel Co. v. United States*, 76-2 U.S. Tax Cas. (CCH) ¶ 9791 (Ct. Cl. 1976); *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969); *Ohio River Collieries Co.*, 77 T.C. 1369.

Although it is obvious that winning the jackpot necessarily identifies the specific person entitled to payment, that event does not determine the fact of liability for such jackpot. That fact was previously determined by HPI's introduction and operation of the progressive slot machines on the casino floor. At the time the guaranteed jackpots were won, all of the facts determining HPI's liability therefor had previously occurred. HPI's accrual of the guaranteed jackpots is consistent with the decisions in *Lukens Steel*, *Harrold*, and *Washington Post*. HPI had irrevocably committed to pay the liability for the guaranteed jackpots. Such liability could not be avoided. The only unknowns at year end were the time payment would be made and the identity of the winning customer. The Claims Court and the Federal Circuit correctly rejected the government's argument and *Nightingale's* holding that deductibility was precluded by such unknown facts (Pet. App. 2a, 14a).

Even if the government's assertion that there can be no "unconditional liability" unless there exists some person or entity to whom the taxpayer is liable (Pet. Br. 31) were accepted, there is no absence of obligees in this case. The Nevada gaming laws, in general, and the cited Regulation, in particular, were designed to insure HPI's unconditional liability to the gaming public pending determination of the member of that class to whom the jackpot would be paid. The Gaming Commission and Board have been delegated the responsibility of enforcing the liability until such time. Such a characterization is entirely consistent with the nature of the obligees in the strip mining cases—the general population of the states in which the strip mining occurred.

The government's rejection of Regulation § 5.110 as the basis for HPI's accrual ignores that the combination of the policies of the Board and the Commission and the statutory sanctions enforcing such Regulation served to insure that HPI's liability for the guaranteed jackpots was an economic certainty. HPI's payoff experience, alone, serves to emphasize this fact. The government's contention that such Regulation does no more than "to place a floor beneath the *amount* of [HPI's] *potential* liability" and indicates only "the minimum amount that a future patron will win" (Pet. Br. 16) (emphasis in original) is consistent with its refusal to recognize that such a liability then exists. This contention, however, fails to consider the random manner in which the winning combination of symbols determining a guaranteed jackpot occur. Potentially, at any point in time, the next play of the machine will produce a guaranteed jackpot in the amount shown on the machine's meter. Thus immediately prior to each play, the government's "future patron" and the exact amount of the guaranteed jackpot (not the minimum) which may be won by such patron is known. Because of the random manner by which guaranteed jackpots will occur, a coin played in any of HPI's progressive slot machines at 12:01 a.m. on July 1, the commencement of its fiscal year, might well yield a guaranteed jackpot in the amount shown on the meter at that time. The government, in its analysis, has completely missed this point.

2. The government argues that the guaranteed jackpots may represent a *probable* liability of HPI which would only "likely" or "eventually" be incurred but that such probability was at best remote and subject to indefinite deferral by HPI (Pet. Br. 13-14). These observations are inaccurate and misleading in that they ignore

that payments of guaranteed jackpots occur, not by a predetermined number of plays, but at random, and thus are not within the discretion or practical control of a licensee. Such contentions further ignore that industry competition demands that realistic chances to win the guaranteed jackpots be offered to the gaming public. As previously noted, the average time for payout of HPI's guaranteed jackpots was 4½ months (J. A. 62). Accrued guaranteed jackpot expense accounted for less than 1% of HPI's gaming revenue for the years in question (J. A. 35-36; Pet. App. 9a). Such facts certainly offer no support to the government's "remoteness" theory but, to the contrary, emphasize the reality of the obligation. The lack of materiality of the guaranteed jackpot expense in the context of HPI's overall financial condition emphasizes the lack of any motivation on HPI's part to unrealistically defer this payment. As the government concedes, there is no evidence in the record which even intimates that HPI engaged in any such manipulative practice nor has the government so contended. In view of the strip mining cases where the taxpayer had theoretical control over the timing of its abandonment of a mine, thus causing its restoration obligation to mature, the government's erroneous implications regarding the remoteness of the guaranteed jackpots are irrelevant in any event.

In *Mooney Aircraft, Inc. v. United States,* 420 F.2d 400 (5th Cir. 1969), the deduction of an accrued expense which was incurred upon the sale of an airplane but which was not payable until such airplane was retired from service was denied because of the twenty to thirty year interval between the accrual and its payment. Here, the accrued expenses were, in general, paid within 4½ months. Notably, in *Mooney,* accural of the expense was found to satisfy the all events test because, as is the case here, the

fact of the liability was certain, the deduction being disallowed on other grounds.

3. The government observes, as did the court in *Nightingale*, that HPI could avoid the liability for the guaranteed jackpots by going out of business (Pet. Br. 14). The court in *Nightingale* used such observation not as a basis for, but only to support, its holding. Properly, the government draws no express conclusion from this observation. Clearly, speculative possibilities, even theoretically voluntary alternatives such as going out of business, which would result in the avoidance of a liability will not prevent its accrual. *Wien Consolidated Airlines, Inc. v. Commissioner*, 528 F.2d 735 (9th Cir. 1976); *Lawyers' Title Guaranty Fund v. United States*, 508 F.2d 1 (5th Cir. 1975); *Zwicker Knitting Mills v. United States*, 80-2 U.S. Tax Cas. (CCH) ¶ 9832 (Ct. Cl. 1980); *Buckeye International, Inc. v. Commissioner*, 49 Tax Ct. Mem. Dec. (CCH) 376, 382 (T.C. 1984).

The record clearly reflects that if HPI were to sell its business, the liability for the guaranteed jackpots would be provided for (J. A. 78) and that the probability of HPI closing its doors or the occurrence of the other similar contingencies suggested by the government are at best highly remote (Affidavit of Philip D. Griffith, J. A. 63). The government has conceded this to be the case (Pet. Br. 15). Further, the government's observation is inconsistent with its concession in its Reply Memorandum in the present case that remote contingencies such as bankruptcy do not preclude accruals under the all events test and its assertion that it was "not contending otherwise" (Pet. Reply Memorandum 3). Indeed, the government has stipulated that HPI cannot avoid payment of the guaranteed jackpot liability (J. A. 15-16; Pet. Br. 2). In

addition, as the Claims Court correctly points out, even if such a remote contingency did occur and the liability were avoided, the tax benefit rule would prevent HPI from obtaining any windfall which might otherwise occur by reason of the guaranteed jackpot liabilities not being paid (Pet. App. 15a). *See Putoma Corp. v. Commissioner*, 601 F.2d 734, 741 (5th Cir. 1979); *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967); Code § 61(a); Treas. Reg. § 1.461-1 (a)(2).

4. The government and the Ninth Circuit in *Nightingale* purport to rely on this Court's decision in *Brown v. Helvering*, 291 U.S. 193 (1934), to conclude that the guaranteed jackpot liability is contingent and thus cannot be accrued. By placing the guaranteed jackpot liability in a category with the type of liability involved in *Brown*, the government and the Ninth Circuit have completely misconstrued the nature of HPI's liability. The government observes that "[i]t often happens that a taxpayer is under a present obligation . . . to make specified future payments upon the happening of specified future events." (Pet. Br. 18). Based on this statement, the government contends that HPI's guaranteed jackpot obligations are contingent liabilities, which position it states is supported by this and other courts (Pet. Br. 18-21). What the government and the Ninth Circuit fail to recognize is that a contingent liability is one which is dependent on future events *which either may or may not occur*. HPI had a present liability, and the fact that such jackpots would be paid was certain not problematical. On the other hand, the occurrence of events giving rise to the liabilities in *Brown* and the other cases the government cites was speculative. In *Brown*, there was no certainty that insurance cancellations, which formed the basis for the accurals there, would ever oc-

cur because such cancellations were subject to the decision of the insureds. Similarly, in *Trinity Construction Co. v. United States*, 424 F.2d 302 (5th Cir. 1970), the liability to purchase life insurance for employees was dependent on the employees' survival until the due date for premium payments which either might or might not occur. In *Bennett Paper Corp. v. Commissioner*, 699 F.2d 450 (8th Cir. 1983), the liability for employee bonuses there accrued was dependent on the employees' continued employment in the following year. Likewise, in *World Airways, Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977), the liability was dependent on the overhauls being performed, the contracts obligating the taxpayer to pay for the overhauls being subject to modification at any time by the parties. In the present case, it was certain that the guaranteed jackpots would be paid by virtue of the Gaming Regulations, the policies of the Board and the Commission, and the Nevada statutes. Determination of the time of payment and identity of the payee awaited only the winning play. The certainty, as contrasted to the indefinite nature of the obligations in the authorities relied on by the government, distinguishes those authorities and renders them not germane to this case.

5. The government characterizes the obligation of HPI for the guaranteed jackpots as analogous to an irrevocable offer, which is accepted by a winning play (Pet. Br. 21). If such characterization is correct, it is obvious that the "acceptance" of such "offer" occurs, not by a winning pull of the progressive slot machine handle, but by the gaming patron's investment of his funds with each play of the progressive slot machine in anticipation of winning the guaranteed jackpot (Affidavit of Jeffrey A. Silver, J. A. 75). Thus, when a machine is operated

on the casino floor, the so-called "irrevocable offer" would seemingly be deemed accepted with each play. Whether the play wins the guaranteed jackpot is irrelevant to the analogy because the presence of a profit or a financial return is not a requirement of a binding contract. This characterization would be entirely consistent with the holdings of the Federal Circuit and the Claims Court.

6. The government exhaustively urges on the Court that the Federal Circuit was improperly influenced in its decision by the coincidence of HPI's treatment of its guaranteed jackpot expense for federal income tax purposes with that required by financial accounting principles (Pet. Br. 21). There is nothing in the opinion of the Federal Circuit to suggest that such was the case. To the contrary, the Federal Circuit did hold, consistent with *Anderson's* view of the purpose of accrual tax accounting, that HPI's treatment of the deduction resulted in the accurate reflection of its taxable income and expense, thus avoiding, as the government urges, a result which would distort its taxable income (Pet. App. 2a). HPI has never contended, and does not now contend, that financial accounting principles should necessarily dictate the result in this case.

The basis of the government's argument is its view of the nature of the guaranteed jackpot liability as an "estimated future expense" or as a "contingent liability." (Pet. Br. 25). It illogically argues that, because financial accounting principles require that liabilities be accrued as soon as they can reasonably be estimated and because the Claims Court and the Federal Circuit permitted accrual of what the government views as an estimated expense, it must necessarily follow that

such courts were guided by financial accounting, and not tax accounting, principles in reaching their decisions. This same fallacious view—that the liability is contingent—has led the government to characterize the courts' sanctioning of the accrual as tantamount to permitting HPI to establish an unauthorized reserve for the liability because to not permit such an accrual would conflict with the matching principles of financial accounting (Pet. Br. 27). The government's reasoning seemingly is that, because in its view the liability is contingent or estimated and not fixed, the courts' decisions allowing its deduction must necessarily be based on financial accounting principles which permit a reserve for liabilities of that type to offset income. To permit such a reserve, it argues, would contravene the Congressional intent manifested in the repeal of Section 462 and violate the teaching of *Thor Power Tool Co.*, 439 U.S. 522. These arguments apparently find their genesis in the government's quotation of two sentences from the Federal Circuit's opinion (albeit in reverse order)[3] (Pet. Br. 22). These arguments completely disregard the holding of the Claims Court and the Federal Circuit that the guaranteed jackpots represent a "fixed liability" that "is not contingent." (Pet. App. 2a). Notably, there is no mention of financial accounting in the Federal Circuit's opinion. Thus the government, by prefacing its argument on the guaranteed jackpot liability being contingent, presumes the resolution of the issue before the Court rather than supporting its position. Such argument serves no purpose other than to confuse

3. The first sentence, in the sequence presented by the government, begins with the phrase "[Here,] the accounting method used by . . . ," and the second sentence begins with the phrase "If we were to require . . . ."

an otherwise straightforward matter—the satisfaction of the all events test by HPI's liability for guaranteed jackpots.[4]

7. The Ninth Circuit in *Nightingale* was concerned that the casino in that case was deducting an expense that was not being matched in the same taxable year with the income of a winning customer. The Ninth Circuit stated that "[a]nother factor of some significance is that the jackpots will not be taxable as income to any person until they are won." *Nightingale*, 684 F.2d at 615. No principle of federal income tax law dictates that a taxpayer may not deduct an accrued expense unless a corresponding amount of income is recognized at that time by another taxpayer. In fact, the recognition of the cash and accrual methods of accounting under Section 446(c) contemplates that there will be timing differences between the recognition of income by one party to a transaction who is on the cash method and the recognition of expense by the other party to the transaction who is on the accrual method. In a transaction between an accrual basis taxpayer and a cash basis taxpayer, the former is obligated to recognize expenses when the all events test is satisfied, while the latter must only report income actually or constructively received. Matching of income and expense between two different taxpayers is not required. Therefore, it is irrelevant to the outcome of this case that there is no

4. The government, without explanation, offers a summary of the economic performance requirement pertaining to the accrual of deductions, which was introduced by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601 (adding Code Sections 461(h) and (i)). The government acknowledges that such requirement is not applicable to the years before the Court (Pet. Br. 29-30). Its reason for this summary is unclear. Perhaps it intends to imply that HPI could not satisfy the economic performance test imposed by the new legislation; however, such a suggestion serves as a tacit admission that there is no support in *applicable law* for the result it seeks in the present case.

matching of income and expense between HPI and its customers.

8. Finally, the government contends, again based on the Ninth Circuit's attempt in *Nightingale* to support its decision, that the allowance of the deduction for the guaranteed jackpots would open the way "for casinos to overcome the restraints of annual accounting in a perfectly legal way. They could put extra machines on the floor on the last day of the tax year with whatever initial jackpot they chose and with whatever odds they liked. Then they could take a current deduction for the full amount even though payment of the jackpots might not occur for many years." (Pet. Br. 32). There was no suggestion that such tax avoidance occurred in *Nightingale,* and the government admits that such an abuse has not occurred in the present case (Pet. Br. 32).

The theoretical manipulability, which the government contends is inherent in HPI's treatment of the guaranteed jackpot expense, ignores (1) the random method by which such jackpots are determined; (2) the practical restraints imposed by industry competition which demand that realistic gaming opportunities be offered; and (3) the immateriality of the expense in the determination of HPI's gaming income. The government suggests that the time value of the accruals provides an incentive for manipulation to occur because, the government says, "their time value alone, as this case demonstrates . . . can involve huge amounts of revenue." (Pet. Br. 31). The aggregate amount of tax involved in this case is some $434,000 for four years, with the largest amount of tax in any one year totalling approximately $173,000 (J. A. 3). The discounted value of this amount would hardly be a "huge amount" in the context of HPI's

financial condition, particularly considering that the average period between payment of guaranteed jackpots was only 4½ months (J. A. 62).

Assuming, *arguendo,* that there were a legitimate basis in fact for such a concern about such manipulations, it would be resolved by Code Section 446(b) which provides that "[i]f the method used [to compute taxable income] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." In any case where it can be demonstrated that an abuse has occurred, the Commissioner has authority under Section 446 to modify a taxpayer's accounting method to insure a clear reflection of income. *See Commissioner v. Hansen,* 360 U.S. 446, 467 (1959); *Lucas v. American Code Co.,* 280 U.S. 445, 449 (1930); *Clement v. United States,* 580 F.2d 422 (Ct. Cl. 1978), *cert. denied,* 440 U.S. 907 (1979). Therefore, although the government concedes that no distortion of taxable income resulted in *Nightingale* or in HPI's case (Pet. Br. 32), a court could disallow a deduction if such abuse were shown to have occurred.

CONCLUSION

For the reasons stated above, the decision of the United States Court of Appeals for the Federal Circuit should be affirmed.

Respectfully submitted,

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No. 85-554

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

HUGHES PROPERTIES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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REPLY BRIEF FOR THE UNITED STATES

Respondent and amici expend much effort seeking to chart a course through the maze of lower court decisions that have applied the "all events" test in varied factual contexts. They portray these cases as yielding "analytical principles * * * firmly established by the overwhelming weight of precedent," and they urge that our position "ignores this precedent and thus the rule of stare decisis" (N.Y. Life Amicus Br. 3).

We confess that we find the thicket of lower court opinions somewhat harder to negotiate. In our view, they add up to a rather incoherent body of law, yielding results not easy to reconcile either with each other or with cardinal precepts enunciated by this Court. Some

of the cases upon which respondent and amici rely antedated this Court's decision in *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961); as Justice Stewart noted in his dissent there (*id.* at 705-706, 713, 715), these cases may well have been disapproved by that decision.[1] A number of the cases come from the Federal Circuit or its predecessor;[2] since the Federal Circuit authored the decision below, they provide no independent support for the holding that we challenge. Many of the cases come from the Ninth Circuit;[3] since the Ninth Circuit wrote *Nightingale* v. *United States*, 68 .2d 611

[1] See, *e.g.*, *Harrold* v. *Commissioner*, 192 F.2d 1002 (4th Cir. 1951) (reserve for liability to restore strip-mined land); *Denise Coal Co.* v. *Commissioner*, 271 F.2d 930 (3d Cir. 1959) (same); *Schuessler* v. *Commissioner*, 230 F.2d 722 (5th Cir. 1955) (reserve for liability to discharge guaranties); *Beacon Publishing Co.* v. *Commissioner*, 218 F.2d 697 (10th Cir. 1955) (taxability of prepaid subscription income); *Pacific Grape Products Co.* v. *Commissioner*, 219 F.2d 862 (9th Cir. 1955) (reserve for future shipping costs). These cases are discussed and relied upon at Resp. Br. 11, 12, 14, 15; N.Y. Life Amicus Br. 11, 15; and Transamerica Amicus Br. 5, 7, 14, 16, 17, 20.

[2] *E.g.*, *General Dynamics Corp.* v. *United States*, 773 F.2d 1224 (Fed. Cir. 1985), petition for cert. pending, No. 85-1385; *Zwicker Knitting Mills* v. *United States*, 80-2 U.S. Tax Cas. (CCH) ¶ 9832 (Ct. Cl. 1980); *Crucible Inc.* v. *United States*, 591 F.2d 643 (Ct. Cl. 1979); *Eastman Kodak Co.* v. *United States*, 534 F.2d 252 (Ct. Cl. 1976); *Inland Steel Co.* v. *United States*, 76-2 U.S. Tax. Cas. (CCH) ¶ 9791 (Ct. Cl. 1976); *Washington Post Co.* v. *United States*, 405 F.2d 1279 (Ct. Cl. 1969). See Resp. Br. 14, 15, 18; N.Y. Life Amicus Br. 5, 10, 11, 13, 14, 18; Transamerica Amicus Br. 6, 7, 12.

[3] *E.g.*, *ESCO Corp.* v. *United States*, 750 F.2d 1466 (9th Cir. 1985); *Kaiser Steel Corp.* v. *United States*, 717 F.2d 1304 (9th Cir. 1983); *World Airways, Inc.* v. *Commissioner*, 564 F.2d 886 (9th Cir. 1977); *Wien Consolidated Airlines, Inc.* v. *Commissioner*, 528 F.2d 735 (9th Cir. 1976); *Crescent Wharf & Warehouse Co.* v. *Commissioner*, 518 F.2d 772 (9th Cir. 1975); *Pacific Grape Products Co.* v. *Commissioner*, 219 F.2d 862 (9th Cir. 1955). See Resp. Br. 11, 12, 14, 18, 20; N.Y. Life Amicus Br. 7, 8, 10, 11, 13, 17, 19, 20.

(1982), the decision in conflict with the decision below, and upon whose reasoning we rely, they scarcely constitute "established precedent" (N.Y. Life Amicus Br. 4) in support of respondent's position. And one important group of cases, from which respondent and amici seek to derive the linchpin of their argument, actually supports, as we shall explain below, not respondent's position but ours.

We think that one will find little profit and less cheer in seeking the bottom of this pit. We have long viewed the lower courts' case law concerning the all events test as unsatisfactory, both because it lacks intellectual coherence and because (to be frank) we have tended to lose too many cases that we should have won. The decision below for the first time produced a square conflict in the circuits that has enabled us to seek this Court's review. Now that the question is here, we think it should be answered by resort to first principles and common sense. It is to those that we now turn.

1. Respondent contends (Br. 7) that "the fact of [its] liability for the jackpots resulted from [its] operation of progressive slot machines on its casino floor." This contention rests on the theory that Nevada gaming establishments do business within a regulatory framework, marked out by the Gaming Commission's policies and rules, which make it likely that progressive jackpots will eventually be paid. Amici similarly urge this Court to adopt "the general principle that * * * statutory, regulatory, and contractual obligations * * * create liability with sufficient initial certainty to satisfy the all events test" (N.Y. Life Amicus Br. 20; see Transamerica Amicus Br. 5-6). In essence, respondent and amici argue that the mere status of being a gambling casino operator, given the existence of the Gaming Commission's rules, creates a "fixed and unconditional" liability for progressive jackpots (Resp. Br. 9).

This argument misconceives the kind of liability that is relevant in applying the all events test. That test pre-

supposes, not an abstract, inchoate, or generalized obligation, but the specific obligation *to make a payment*. As this Court wrote in *United States* v. *Anderson*, 269 U.S. 422 (1926), an expense is properly deductible for federal tax purposes when all the events have occurred that fix its amount and "determine the liability of the taxpayer to pay it" (269 U.S. at 441).

Generally speaking, statutes and regulations do not, in and of themselves, impose upon particular persons the obligation to pay particular sums. Rather, they subject a class of regulated persons to an inchoate obligation to make payments upon the occurrence of specified facts or conditions. It is not merely the existence of a statute, in other words, but the conjunction of the statute with the happening of the relevant events, that causes the inchoate liability inherent in the regulatory framework to ripen into a concrete obligation on the part of a particular individual to pay something to someone.

This point may be illustrated by *United States* v. *Anderson*, the decision in which the "all events" test was enunciated. The taxpayer there was a manufacturer of munitions and, as such, was subject to federal excise tax on munitions that it manufactured and sold (269 U.S. at 435, 440-441). This Court held that, in computing the taxpayer's income tax liability for 1916, it was proper to accrue a deduction for the excise tax payable with respect to munitions manufactured and sold by the taxpayer during 1916, even though actual payment of the excise tax was not due until the following year (*id.* at 440-441). Contrary to the contention of amicus (N.Y. Life Amicus Br. 9), the Court in reaching that conclusion did not rely merely on the existence of the munitions tax statute, or on the taxpayer's status as a munitions manufacturer. Rather, the Court relied on the fact that the taxable events giving rise to the manufacturer's 1916 munitions tax liability—namely, the manufacture and sale of munitions during 1916—had by definition occurred as of December 31 of that year. It was the

happening of those taxable events that converted the inchoate obligation represented by the excise tax law into a concrete liability to pay the tax.

This Court's reasoning in *Anderson* shows the error of respondent's argument here. In order to accrue a deduction for progressive jackpots as an "expense incurred," it is not sufficient that respondent operates a casino with slot machines on the floor or that respondent does business subject to the supervision of the Nevada Gaming Commission. The Commission's regulations do not require respondent to pay a jackpot unless and until it is actually won by a customer, just as the statute involved in *Anderson* did not require the manufacturer to pay a munitions tax unless and until munitions were actually manufactured and sold. Until a customer has hit the winning combination of symbols, the Nevada regulatory scheme is but a brooding omnipresence. The event that causes this inchoate obligation to ripen into the liability *to make a payment* is the winning pull of the slot machine handle. Until that event occurs, "all the events" necessary to fix the casino's liability to pay a particular progressive jackpot have not materialized.

2. In arguing that its year-end jackpot liabilities are "fixed and unconditional," respondent relies chiefly upon the Gaming Commission regulation that prohibits casinos from turning back the meters on their progressive slot machines (Br. 9). As we showed in our opening brief (U.S. Br. 15-16), however, this regulation, while obviously relevant in determining the *amount* of respondent's *potential* year-end obligation, and thus in determining whether respondent might satisfy the *second* part of the all events test, has absolutely no relevance in determining whether the first, or "fixed liability," component of that test has been met.

This point may be demonstrated by considering what life was like for Nevada casinos before the Gaming Commission propounded the regulation in question. Previously, a casino surely had a contractual obligation to

pay to a winning customer whatever amount was shown on the progressive jackpot meter at the moment of victory. This contractual obligation was buttressed by regulatory requirements, since the Gaming Commission was apparently authorized to impose fines or other sanctions upon casinos that wrongfully refused to pay a progressive jackpot or other prize to a winning customer. See Nev. Rev. Stat. § 463.310 (1967); J.A. 53-54, 59, 77. This contractual and regulatory obligation, of course, was contingent at the close of the taxable year, for neither the casino's implied contract with its customers nor the Gaming Commission's regulations required a casino to pay a jackpot unless (1) a customer gambled the requisite amount of money and (2) the winning combination of symbols appeared on the face of the machine.

The Commission's promulgation in September 1972 of its rule prohibiting the turning back of jackpot meters in no way changed the contingent nature of this year-end obligation. That rule provided merely that "[n]o payoff indicator shall be turned back to a lesser amount, unless the amount by which the indicator has been turned back is actually paid to a winning player" (Nev. Gaming Reg. § 5.110(2) (1972) (reprinted in J.A. 55)). Since this new rule did not require a jackpot to be paid unless won, the rule did not alter the terms of a casino's preexisting contractual and regulatory obligation, which was to pay a jackpot if and only if (1) a customer gambled the requisite amount of money and (2) the winning combination of symbols appeared on the face of the machine.

The principal effect of promulgating the rule against turning back jackpot meters was to lend certainty to the *magnitude* of the casino's contingent liability at the close of its fiscal year. From a financial-accounting standpoint, what prevented a casino prior to September 1972 from accruing its year-end progressive jackpot liability was not the contingent nature of that liability, for, as we have noted (U.S. Br. 25), financial accounting often requires that contingent liabilities be accrued. The difficulty, rather, was that the amount of the liability could not reasonably be estimated. Since a casino was theoretically free to turn back the jackpot meters, there was no assurance that the year-end amounts registered on those meters would still be there when the winning pull of the handle occurred some months or years down the road.

The promulgation of the Commission's rule in September 1972 mitigated this latter uncertainty, since that rule placed a floor, in an amount equal to the year-end meter totals, beneath the casino's potential obligation. Because financial accounting principles "typically require that a liability be accrued as soon as it can reasonably be estimated" (*Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 543 (1979) (footnote omitted)), respondent's accountants determined that those year-end sums should thenceforth "be reported on the financial records of the corporation as accrued liabilities" (J.A. 68, 69). But that does not mean that respondent was entitled to deduct those sums for tax purposes as well. The "all events" test requires not only that the amount of the putative deduction be determinable with reasonable accuracy, but also that the taxpayer have incurred a fixed and unconditional obligation to pay it. As we have shown, respondent had no obligation to pay a jackpot unless and until somebody won it, and the Gaming Commission's new rule had no effect on the contingent nature of that promise. Respondent was thus in no better position after September 1972 than previously to claim a tax deduction for the year-end amounts shown on its jackpot meters.[4]

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[4] Amicus Atlantic City Casino Association endeavors to show "[t]he fixed quality of the accrued jackpot" by hypothesizing that "[a]ny party purchasing a casino property would have to recognize the accrued progressive jackpots as a liability to be assumed" (Br. 9). Although this hypothesis may be correct, the conclusion does not follow from the premise. Contingent liabilities, no less than fixed liabilities, are commonly assumed by purchasers in inter-

3. Respondent and amici dismiss the actual winning of the jackpot by a customer as an event that "ha[s] no effect upon the existence of * * * liability" (N.Y. Life Amicus Br. 13; Resp. Br. 14). As they see it, the casino's obligation is unconditionally fixed when "a machine is introduced on the casino floor" (Resp. Br. 9); the winning pull of the handle, they contend, merely determines the precise amount of the jackpot, the time of actual payment, and "the identity of the ultimate payee" (N.Y. Life Amicus Br. 13; Resp. Br. 14). They assert that "[t]he 'all events' test has never included a requirement that the ultimate payee be identified before an obligation is * * * deductible" (Atlantic City Casino Amicus Br. 10).

We of course agree that, once a taxpayer has incurred an unconditional obligation to make a payment, he may accrue a deduction under the all events test even though payment is not currently due, and even though the amount of the payment is determinable only with "reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)) rather than with perfect precision. That much has been clear for fifty years. But we cannot so readily assent to respondent's assertion about the relevance of "inability to identify the payee" (Resp. Br. 14). That assertion blurs, with what seems studied ambiguity, several ideas that need to be unbundled.

In support of this assertion, respondent and amici rely on a series of lower court decisions involving what may be called "group liabilities."[5] The taxpayer in these cases

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corporate transactions. A buyer, for example, will often assume a seller's liability on pending contested lawsuits. The fact that a liability is capable of assumption thus tells one nothing about whether it is a "fixed" or "contingent" liability for tax accounting purposes.

[5] *E.g.*, *Lukens Steel Co.* v. *Commissioner*, 442 F.2d 1131 (3d Cir. 1971); *Washington Post Co.* v. *United States*, 405 F.2d 1279 (Ct. Cl. 1969); *Willoughby Camera Stores* v. *Commissioner*, 125 F.2d 607 (2d Cir. 1942); *Inland Steel Co.* v. *United States*, 76-2 U.S. Tax Cas. (CCH) ¶ 9791 (Ct. Cl. 1976); *Reynolds Metals Co.* v. *Commissioner*, 68 T.C. 943 (1977). See Resp. Br. 14, 15; N.Y. Life Amicus Br. 10, 11, 13, 14; Atlantic City Casino Amicus Br. 10, 11.

[6] The Commissioner originally declined to follow both *Washington Post Co.* and *Lukens Steel Co.* See Rev. Rul. 76-345, 1976-2 C.B. 134; Rev. Rul. 72-34, 1972-1 C.B. 132. However, in view of the government's persistent lack of success on this issue in the Federal Circuit, a court of nationwide jurisdiction, the Commissioner now rarely challenges deductions in such "group liability" situations, at least where the employer has an unconditional year-end liability to make irretrievable payment to some separate entity like a trust.

is typically an employer that has incurred, by virtue of his employees' past services, a fixed and unconditional obligation to make a payment on their behalf. The immediate payee is generally a fund or trust—*e.g.*, a profit-sharing plan or a supplemental unemployment benefit trust—of which the employees as a class are beneficiaries. In the typical case, the identities of the ultimate employee-beneficiaries, and the exact amounts of their respective beneficial interests, are not known at the close of the tax year. The lower courts have generally permitted the employer to deduct his year-end liability in these circumstances, reasoning that the employer has an unconditional obligation to make payment irretrievably *to the entity*, even though the individuals who comprise the class of beneficial owners may be unidentified.

We may assume for present purposes that these "group liability" cases were correctly decided.[6] But their rationale offers no support for respondent's position. Respondent at the close of its tax year has incurred no liability to make payment to a plan, trust, or other entity; on the contrary, respondent has no obligation to pay a jackpot to anyone or anything unless somebody wins it. We have little doubt that, if respondent's jackpots had in fact been won before the close of its tax year, it would be entitled to a deduction even though it did not happen to know the winners' names. What prevents a deduction in our view is not that respondent does not know the names of the payees, but that *no payees exist* at the close of the

tax year. An unconditional obligation presupposes both an obligor and an obligee. The obligee may be an individual or an entity; the obligee may be identifiable or unknown; but there must be an obligee.

Our point may be illustrated by a pair of examples. Assume that a manufacturer has suffered a serious industrial accident that has injured many people in the area surrounding its plant. Assume that the manufacturer, before the close of its tax year, has unconditionally agreed, based on negotiations with representatives of the injured parties, to make a payment in an ascertainable amount to a trust for the benefit of those persons. Assume that no portion of this payment can ever revert to the manufacturer, but must inevitably be distributed to members of the class. In our view, the manufacturer would be entitled under the "all events" test to a deduction for the amount it had committed to pay the trust, even though the names of the ultimate beneficiaries might not then be known.[7]

On the other hand, assume that a sporting goods company has committed itself to hold a golf tournament during the next year, or annually for each of the next 10 years. Assume that the company has offered prize money of $1 million for each tournament, to be shared among each event's top 50 golfers. Assume that state law requires this offer to be irrevocable, and that the tournaments in the normal course of business must be held. In our view, the company would not be entitled to deduct, in the year it announces the future tournament or tournaments, the sum that it has offered by way of prizes.

[7] In 1984, Congress amended the Code to provide that, in order to deduct expenses attributable inter alia to tort liabilities, a taxpayer must satisfy, not only the "all events" test, but also a new "economic performance" test. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601 (adding I.R.C. § 461(h)). See U.S. Br. 29-30 n.4. The new law generally provides that, where a taxpayer's liability requires payment to another person and arises out of a tort, "economic performance occurs as payments to such person are made" (I.R.C. § 461(h)(2)(C)(ii)). The Treasury Department has not yet issued regulations concerning this provision. See I.R.C. § 461(h)(2) (first clause).

What prevents such an accrual is not the fact that the company is unable to name the golfers who will win the tournaments. It is, rather, the fact that the tournaments have not yet been held and the prizes have not yet been won.

Needless to say, we think that the latter example rather closely resembles the situation here. As noted in our opening brief (at 21), respondent's obligation with respect to its progressive jackpots is in the nature of the offer of a prize, a prize that may be won if and when some future patron pays his money and hits the winning combination of symbols. Indeed, the Nevada Gaming Commission's rules specifically describe progressive jackpots as being "offered to the public as prizes" (J.A. 56). So long as respondent chooses to stay in the gaming business, those rules require that respondent's offer be irrevocable. But respondent's *liability* on the offer is nevertheless contingent until someone *accepts* the offer by satisfying the conditions for payment. Respondent does not have an "unconditional liability" unless there exists some person or entity to whom it is liable, and respondent is not liable to anyone until somebody wins the prize.[8]

4. As a framework for deciding cases under the all events test, amicus New York Life proposes an analysis based on "conditions precedent" and "conditions subse-

[8] Respondent asserts that, even if one accepts our intention that an obligation presupposes an obligee, "there is no absence of obligees in this case"; as respondent sees it, the Nevada regulatory scheme imposes on casinos an "unconditional liability to the gaming public" (Br. 15). "The gaming public," however, is indistinguishable from "the world at large"; an obligation to the world at large is the very sort of abstract liability that cannot support a deduction under the all events test. See pages 2-5, *supra*. "The gaming public" does not define a class of beneficiaries whose past services give them enforceable rights to a trust corpus. Compare, *e.g., Willoughby Camera Stores*, 125 F.2d at 609. To the contrary, "the gaming public" is but a tautological description of the population from which possible future jackpot winners—who by definition will be members of the gaming public—must inevitably come. A "liability to the gaming public" is but a substitute for a "contingent liability."

quent" (N.Y. Life Amicus Br. 3-15). In its view, a "condition precedent" is a fact or event whose occurrence is necessary to create a tax-deductible liability. A "condition subsequent" is a fact or event which "may act to terminate an existing liability" and whose possible future occurrence should not prevent accrual (*id.* at 6). Other events, such as those which "affect the timing or manner in which [the] liability is ultimately paid or satisfied, or the identity of the ultimate payee," are said to be neither "conditions precedent" nor "conditions subsequent" and to "have no impact on accruability" (*id.* at 6, 13). Amicus says that this mode of analysis, derived from the law of contracts, is "uniformly recognized in the application of the all events test" (*id.* at 6-7).

The mode of analysis that amicus proposes is certainly not "uniformly recognized" (N.Y. Life Amicus Br. 6) in this Court's tax decisions; in fact, amicus cites no case in which this Court has employed it. Although "condition precedent" and "condition subsequent" crop up occasionally in lower-court exegeses of the all events test (see *id.* at 12-13), that mode of reference, far from being "firmly established by the overwhelming weight of precedent" (*id.* at 3), is quite desultory and haphazard. And while the analytical framework that amicus proposes may seem tempting to those of a philosophical bent—it is a temptation to which we have succumbed (Reply Memo. 3)—we doubt that it will prove, in the generality of cases, an auspicious road down which to travel.

The distinction between a "condition precedent" and a "condition subsequent" is a point of metaphysics with which the law of contracts grappled long and unsuccessfully. "In one sense," Holmes wrote, "all conditions are subsequent; in another, all are precedent." *The Common Law* 316 (1938 ed.)[9] "The truth is that [these] terms

[9] Less epigrammatically, Holmes' discussion of the matter (*The Common Law*, *supra*, at 316-318) was as follows:

> The conditions which a contract may contain have been divided by theorists into conditions precedent and conditions subsequent. The distinction has even been pronounced of great importance. It must be admitted that, if the course of pleading be taken as a test, it is so. In some cases, the plaintiff has to state that a condition has been performed in order to put the defendant to his answer; in others, it is left to the defendant to set up that a condition has been broken. * * * * * The point at which the law calls on the defendant for an answer varies in different cases. Sometimes it would seem to be governed simply by convenience of proof, requiring the party who has the affirmative to plead and prove it. Sometimes there seems to be a reference to the usual course of events, and matters belong to the defence because they are only exceptionally true.

are meaningless until the fact constituting the condition is related to something else. If it is precedent, it must be precedent to something; and if it is subsequent, it must be subsequent to something. Therefore, the first question must always be: Precedent to what? and subsequent to what?" 3A A. Corbin, *Corbin on Contracts* § 739, at 442 (1960 ed.). After struggling for years with these questions, modern scholars have generally found much wisdom in "Holmes' skeptical approach to the validity of the distinction between conditions precedent and subsequent." F. Kessler & G. Gilmore, *Contracts* 823 (2d ed. 1970). See L. Fuller & R. Braucher, *Basic Contract Law* 633-636 (1964). Indeed, the Second Restatement of Contracts revised its predecessor "to eliminate the terms 'condition precedent' and 'condition subsequent,'" the reporters noting that "[t]his terminology has long been criticized and has caused confusion * * *." Restatement (Second) of Contracts § 224 & reporter's note (1981). Scholars have suggested that these terms are best viewed as "ghosts from the Nineteenth Century." J. Jackson & L. Bollinger, *Contract Law in Modern Society* 1046-1049 (1980).[10]

[10] At the margins, of course, a mode of analysis based on "conditions precedent" and "conditions subsequent" may seem to produce sensible results. A person's signing of a contract may generally be described as a "condition precedent" to his liability on the contract; and a discharge in bankruptcy may usually be described as a "condition subsequent" that divests him of an existing obligation. But the distinction is of little use in complex cases presenting nicer questions. It often happens, for example, that an employer will have an obligation to make future payments on

If one were to adopt the mode of analysis that amicus proposes, it seems to us that the inquiry would lead in any event to the result that we urge. In deciding whether the winning pull of a slot machine handle (or anything else) is a condition precedent, "the first question must always be: Precedent to what?" (3A A. Corbin, *supra*, at 442). The "what" for purposes of the all events test is, as we have shown (pages 3-4, *supra*), the liability to make a payment. Since respondent has no liability to make a payment of a progressive jackpot unless and until someone wins it, the winning pull of the handle, as the Ninth Circuit reasoned, is "most naturally regarded as a condition precedent" to the creation of a fixed obligation. *Nightingale* v. *United States*, 684 F.2d 611, 614 (1982).[11]

5. In our opening brief (at 21-32), we emphasized the important role that the all events test plays in the system of tax accounting. That test "is designed to assure that taxpayers will not obtain deductions for expenditures that might never occur," and it thus serves the goal of tax accounting by "seek[ing] certainty of liability rather than probability." *World Airways, Inc.* v. *Commissioner*, 62 T.C. 786, 805 (1974), aff'd, 564 F.2d 886 (9th Cir. 1977). We suggested (U.S. Br. 22) that the Federal Circuit's misapplication of the all events test may have owed to a neglect of the distinction, oft recognized in this Court's decisions, between tax and financial accounting. See, *e.g.*, *Thor Power Tool Co.*, 439 U.S. at 538-544; *American Automobile Ass'n*, 367 U.S. at 690-693.

Respondent and amici strive in various ways to evade the force of these decisions. One amicus argues that divergences between tax and financial accounting are "scarcely a matter for celebration" and characterizes our argument as a "makeweight" (Atlantic City Casino Amicus Br. 11 n.9). Respondent asserts that "[t]here is nothing in the opinion of the Federal Circuit to suggest" that the courts below were "influenced * * * by financial accounting principles" (Br. 21) and contends that this issue is not raised here at all. Amicus Transamerica Corporation urges by contrast that the courts below gave "substantial weight" and "particular emphasis to the principles of financial accounting * * * in deciding whether [r]espondent had met the 'all events' test," but contends that those courts acted correctly in doing so (Br. 8, 9, 17). It urges that this Court "should resolve close technical questions of accrual accounting" by considering whether the taxpayer's treatment "complies with generally accepted accounting principles" (*id.* at 8).

The drift of these arguments runs counter to 50 years of this Court's decisions, a fact about which Transamerica is particularly frank. It dismisses *Brown* v. *Helvering*, 291 U.S. 193 (1934), a decision upon which we rely (U.S. Br. 18-20), in a single sentence (Amicus Br. 13). It asserts that a major premise of *American Automobile Ass'n*, 367 U.S. at 694-697, upon which we likewise rely

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account of employees' past services, such payments being conditioned on those individuals' being alive, or still being employed, at the relevant future time. *E.g.*, *Trinity Construction Co.* v. *United States*, 424 F.2d 302 (5th Cir. 1970); *Bennett Paper Corp.* v. *Commissioner*, 699 F.2d 450 (8th Cir. 1983). See U.S. Br. 20-21. In such cases, the employee's continued employment or survival might be called a "condition precedent" whose occurrence is necessary to create a liability; or the employee's termination or death might be called a "condition subsequent" whose occurrence causes forfeiture of the employee's rights and thus divests the employer of an existing liability. In our view, it makes little difference how the condition is described; the relevant question is whether the taxpayer at year's end has a fixed and unconditional obligation to make a payment. The courts of appeals have held that an employer in such situations does not have such an obligation (*Trinity Construction Co.*, 424 F.2d at 305; *Bennett Paper Corp.*, 699 F.2d at 453), and amicus (N.Y. Life Amicus Br. 7) seems to agree with our contention that the courts were correct in so holding.

[11] Amicus asserts (N.Y. Life Amicus Br. 19) that the Ninth Circuit in *Nightingale* "failed even to consider the possibility that the Nevada Gaming Commission regulation might create an existing liability." That assertion is incorrect. The Ninth Circuit discussed the Nevada regulatory scheme, including the regulation in question, at some length (684 F.2d at 612-613).

(U.S. Br. 28-29), is "flatly contradicted by [the] legislative history" cited by the Court (Amicus Br. 21 n.6). It says that *Thor Power Tool Co.*, 439 U.S. at 538-544, involved a "glaringly bad fact situation" that assertedly "led the Court * * * to make some overbroad generalizations about the weight properly to be accorded to generally accepted accounting principles" (Amicus Br. 22). It dismisses various passages in that opinion as "faulty" or "simply wrong," and urges the Court to "clarify" statements that supposedly have "misled many courts" (*id.* at 14 n.4, 26). And in contending that financial accounting principles should carry the day "[a]bsent a countervailing tax policy" or "[w]here the Commissioner cannot demonstrate with certainty that a taxpayer has failed the 'all events' test" (*id.* at 12, 24), amicus urges the very shift in the burden of proof, the very "presumption * * * against the Treasury" (439 U.S. at 539, 540), that the Court in *Thor Power Tool Co.* explicitly rejected.

Transamerica in our view has at least identified the dragon that it must slay. And while we think that this Court's decisions can parry those thrusts without our help, we would make one point about Transamerica's position. Its central thesis is that an expense should be deductible, for tax as for financial accounting purposes, "where incurrence of the liability is 'probable,' *i.e.*, when future events confirming the fact of liability are likely to occur" (Amicus Br. 25). The centrality of this thesis is particularly clear in the instant case, since respondent's incurrence of jackpot liabilities is entirely a function of gambling odds, which reflect the laws of probability in a rather pure form. Amicus acknowledges (*id.* at 25) that "some exercise of judgment may be required in interpreting the word 'probable.'" But it urges the Court to defer on this score to the judgment of taxpayers' accountants, who, by applying "scientific accounting principles" (*id.* at 2, 11, 14, 15, 16), should decide when expenses are sufficiently likely to occur so as to be deductible in computing taxable income.

As we have noted (U.S. Br. 31-32), Transamerica's argument is precisely the argument that the Court in *Thor Power Tool Co.* explicitly rejected. The tax laws, the Court said, cannot tolerate an outcome under which a taxpayer "could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay" (439 U.S. at 544). The Court emphasized that what amicus calls "scientific accounting principles" (Transamerica Amicus Br. 2, 11, 14, 15, 16) actually permit "a range of 'reasonable' treatments, leaving the choice among alternatives to management" (439 U.S. at 544).[12] The Court quite properly held that such variances are unacceptable "in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax" (*ibid.*). There is no reason for the Court to depart from that holding here.

CONCLUSION

For these reasons and those set forth in our opening brief, it is respectfully submitted that the judgment of the court of appeals should be reversed.

CHARLES FRIED
Solicitor General

APRIL 1986

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[12] Indeed, the Court noted one commentator's suggestion that accountants "are quite prone to define 'generally accepted' as 'somebody tried it'" (439 U.S. at 544 n.2, quoting Cannon, *Tax Pressures on Accounting Principles and Accountants' Independence*, 27 Acct. Rev. 419, 421 (1952)).

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IN THE

Supreme Court of the United States

October Term, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPEPTIES, INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF OF ATLANTIC CITY CASINO ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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No. 85-554

IN THE

Supreme Court of the United States

October Term, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPERTIES, INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF OF ATLANTIC CITY CASINO ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

STATEMENT OF INTEREST

The Atlantic City Casino Association (the "ACCA") is a not-for-profit corporation of the State of New Jersey. The ACCA represents all eleven operating casino hotels in Atlantic City, New Jersey: Adamar of New Jersey, Inc.; Bally's Park Place, Inc.; Boardwalk Regency Corp.; Castle Associates, a New Jersey Limited Partnership; Claridge at Park Place, Inc.; Elsinore Shore Associates; GNOC Corp.; Greate Bay Hotel and Casino, Inc.; Harrah's Associates, a New Jersey General Partnership; Marina Associates, a New Jersey General Partnership; and

Resorts International, Inc. ACCA members employ approximately 40,000 people.

Like respondent Hughes Properties, ACCA's members are licensed to conduct casino gaming operations subject to extensive state regulation. *See* N.J. Stat. Ann. §5:12-1, et seq. The Atlantic City casinos offer progressive jackpots on their slot machines under regulations established by the New Jersey Casino Control Commission. *See* N.J. Admin. Code §19:45-1:39 (pp. A-1 to A-4 *infra*.)[1]

All ACCA members are accrual-basis taxpayers, and all account for progressive jackpot liability on the accrual basis for financial statement purposes. Accordingly, ACCA has a concrete interest in the outcome of this case. The decision below follows the established principle that a definite liability may be deducted from income by an accrual-basis taxpayer even if the obligation has not yet been paid. The government challenges that decision on the primary ground that the payee (or jackpot winner) is not known at the time the expense is accrued. The government's argument, however, ignores the practical realities of the casino industry. In this pervasively regulated industry, there can be no question that progressive jackpots are a definite liability which may be deducted for tax purposes when they accrue.

INTRODUCTION AND SUMMARY OF ARGUMENT

The government challenges the deduction of the accrued liability for progressive slot machine jackpots on the basis of a single fact: that on the last day of a casino's tax year, "there exist[s] no person at all who could assert any possible claim to those funds." Pet. Br., p. 8;[2] *see id.*,

1. For the Court's convenience, certain New Jersey statutory and regulatory provisions relevant to the issues in this case are reproduced in an appendix to this brief (pp. A-1 to A-4).

2. This brief will refer to the Brief for the United States, filed January 30, 1986, as "Pet. Br., ____."

at 13 (identical phrase); *id.*, at 14 (if respondent sold its business, it would have "no liability, and would never have any liability, to pay the jackpots to anyone"); *id.*, at 21 ("respondent was not liable to anyone . . ."). To be sure, the government offers other rhetorical points. The government's brief discusses several decisions applying the "all events" test to accrual-basis taxpayers (*id.*, at 11-13, 18-21), expounds on the differences between tax accounting and financial accounting (*id.*, at 21-28), reviews legislative events in 1954 and 1955 which have no impact on this case (*id.*, at 28-29), and concludes with a call for vigilance against "tax avoidance" (*id.*, at 30-32).

The government's basic position, however, hinges on a single point: that at the end of the year no specific individual can claim an accrued progressive slot machine jackpot. That is the only "event" concerning liability which is not plainly established for the accrued progressive jackpots. Because the identity of the payee is unknown, the government insists, the obligation to pay that jackpot is not sufficiently fixed to allow deduction of the liability for tax purposes.

The government's argument betrays a fundamental ignorance about the pervasiveness of modern casino regulation, which is illustrated both by the Nevada regulations discussed by the Claims Court below and by the New Jersey regulations outlined in this brief. That extensive regulatory structure ensures that progressive jackpot liability is fixed, and that a casino licensee would risk serious sanctions if it manipulated its progressive slot machines for tax advantages in the manner imagined by the government.

Finally, the "all events" test does not bar deduction of an accrued liability by an accrual-basis taxpayer unless the identity of the payee is known. The "all events" test sets two requirements: that liability is established and that the amount of liability is reasonably ascertainable. State gaming regulations establish both the fact and the amount of liability for progressive slot machine

jackpots. That the payee cannot be identified is a peculiar factual circumstance which in no way alters the propriety of deducting the accrued liability for progressive slot machine jackpots.

I.

Casinos and Progressive Slot Machines Are Subject To Pervasive State Regulation

The lower courts allowed deduction of accrued progressive jackpots primarily because of Nevada's regulation of progressive slot machines. Petition for Certiorari, at 7a-9a (hereinafter "Petition"). As the Claims Court noted, the obligation to pay progressive jackpots "can be enforced by the Nevada Gaming Commission." *Id.*, at 14a. Indeed, that court concluded that "only the Nevada State Legislature can alter the 'guaranteed' jackpot liabilities of the casinos in that state." *Id.*, at 19a.

This important conclusion is powerfully reinforced by the example of New Jersey's regulation of casinos.[3] As the New Jersey Supreme Court wrote in *Knight v. Margate*, 86 N.J. 374, 380-81, 431 A.2d 833 (1981), in New Jersey "[t]he statutory and administrative controls over casino operations . . . are extraordinarily pervasive and intensive." Calling the regulatory scheme "both comprehensive and minutely elaborate," the state's highest court observed that "[o]ver 11 statutory articles and almost 200 separate provisions cover virtually every facet of casino gambling and its potential impact on the public." *Id.* at 381.

3. The revelance of the New Jersey experience was conceded in the government's petition for certiorari, which expressed alarm about the possible impact of this decision on the tax liability of New Jersey casinos. *See* Petition, at 16. The government's projection of the revenue consequences of the challenged deduction is subject to serious question, however. Indeed, in some years the accrual method may result in a smaller deduction than would cash-basis accounting, as appears to have been true for respondent Hughes Properties in 1976. *See* Petition, at 9a.

A. The Licensing Process

The heart of the New Jersey regulatory scheme is the licensing process. Each casino-hotel must be licensed after an extensive inquiry into the financial condition, operational plans, and integrity of the applicant and each of its officers, directors, principal employees, lenders, mortgagees, bond holders and investors. N.J. Stat. Ann. §§5:12-80 through 5:12-88; N.J. Admin. Code §19:41-3.1. There are further proceedings for licensing "casino key employees," §5:12-89, for licensing general casino employees, *id.*, §5:12-90, for registration of all hotel employees, *id.*, §5:12-91, for licensing of "casino service industries" (such as gaming equipment dealers, food and beverage suppliers, and garbage handlers), *id.*, §5:12-92, and for registration of all labor organizations for casino employees, *id.*, §5:12-93.[4] A casino license is subject to annual renewals by the Commission. *Id.* §5:12-139.

The licensing process can be grueling. Apparently strong applicants — such as Hilton Hotels Corporation — have been denied a license by the state Casino Control Commission.[5] Indeed, one Atlantic City licensee found its New Jersey license under challenge in 1982 due to its

4. *See Brown v. Hotel and Restaurant Employees and Bartenders Int'l Union Local 54*, 104 S. Ct. 3179 (1984) (state regulation of unions subject to Casino Control Act not preempted by federal labor law).

5. *See* "One Casino Wins, Another Loses," N.Y. Times, March 3, 1985, p. 6, col. 1. In *In re Boardwalk Regency Corp. Casino License*, 90 N.J. 361, 447 A.2d 1335, *appeal dismissed for want of substantial federal question sub nom. Perlman v. Attorney General of New Jersey*, 459 U.S. 1081 (1982), the New Jersey Supreme Court affirmed a decision denying a casino license unless the applicant totally removed two directors from its operations and from the operations of its unlicensed, non-New Jersey subsidiaries.

supposed violations of Puerto Rico's patently unconstitutional prohibition on casino advertising. *See* Jurisdictional Statement in *Posadas de Puerto Rico Associates v. Tourism Co. of Puerto Rico*, No. 84-1903, pp. 11-12.

Finally, the Casino Control Commission has at its disposal a broad range of sanctions for misconduct, including fines of up to $100,000, N.J. Stat. Ann. §§5:12-111 through 5:12-115, license revocation, *id.*, §5:12-129, or imposition of a conservatorship of indeterminate length, *id.*, §§5:12-130.1 through 5:12-130.11. Indeed, one casino was closed by Commission order on the Saturday after Thanksgiving for a regulatory violation.[6] The Nevada Gaming Commission has at its disposal a comparable array of tools for regulating casinos. *See* Nev. Rev. Stat. §463.310 (fines, suspension and revocation); *id.*, §463B.010, *et seq.* (authorizing appointment of "supervisor" to operate casino if license lapses or is suspended or revoked).

B. Slot Machine Regulation

The New Jersey slot machine regulations, like those in Nevada, are extensive. Each individual machine must be licensed as meeting uniform electrical and mechanical standards. N.J. Stat. Ann. §5:12-100(h). Each machine must display the manufacturer's serial number, a casino identification number, and a description of the rules of play. N.J. Admin. Code §19:45-1.37(a). No slot machine may be moved without written approval from the state and full recording of the status of the machine's jackpot. *Id.*, §19:45-1.38. Each slot machine "shall have a minimum payout of 83%," N.J. Stat. Ann. §5:12-100(e), thereby setting a floor under the odds on any slot machine. Jackpot payout procedures are painstakingly detailed. N.J. Admin. Code §19:45-1.40. If a licensee changes or modifies a slot machine without state approval, or otherwise violates the slot machine regulations, the licensee faces sanctions up to and including revocation of its casino license. N.J. Admin. Code §19:46-1.30.

6. "Casino Panel Shuts Caesars on Nov. 30," Atlantic City Press, Oct. 10, 1985, p. 1.

New Jersey has special regulations concerning progressive slot machines. No progressive slot machine may be installed until the Casino Control Commission approves "[t]he initial and reset amounts" for the machine's meters, the machine's security system, and the "proposed rate of progression for each machine." N.J. Admin. Code §19:45-1.39(e).

Like Nevada, New Jersey requires that no meter on a progressive slot machine "shall be turned back to a lesser amount unless the amount indicated has been actually paid to a winning patron," or has been recorded for prompt payment under Commission rules, or, in case of a mechanical breakdown, unless the jackpot amount has been transferred to another progressive slot machine as approved by the Commission. *Id.*, §19:45-1.39(f) and (k). Moreover, once a progressive slot machine has been installed, "the rate of progression and the probability of hitting the combination that will award the progressive jackpot may not be changed until there has been a winner of the payout amount registered" or the payout limit has been reached. *Id.*, §19:45-1.39(g). Consequently, the odds on winning the progressive jackpot amount cannot be changed once they have been set. The progressive jackpots also are subject to the general requirement that slot machines have a payout rate of 83 percent, although the actual payout rate is often higher. *See Casino Chronicle*, Dec. 1985, p. 4 (for all Atlantic City casinos, slot machine payout rate for month was 87.5%).

Thus, the state of New Jersey must approve the installation of every progressive slot machine and the machine's rate of progression. No progressive slot machine meter can be turned back and neither the rate of progression nor the odds of winning can be changed. The progressive slot machines must pay out at a rate of at

least 83 percent. If a machine malfunctions, it may be removed from the floor so long as it is returned within five days or, if not returned, so long as its progressive jackpot amount is added to another progressive slot machine in a manner approved by the Commission. Violations of these requirements can result in monetary sanctions or suspension or revocation of a casino license.

II.

Under The "All Events" Test, Progressive Jackpots May Be Deducted As An Accrued Liability

Congress has authorized the deduction from income of accrued but unpaid liabilities so long as the taxpayer reports his entire income on an accrual basis and so long as there is no resulting distortion of the taxpayer's income. I.R.C. §§446, 461. In *United States v. Anderson*, 269 U.S. 422 (1926), the Supreme Court explained the wisdom of that policy. Writing for the Court, Justice Stone noted that the taxpayer's "true income for the year [ ] could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year." *Id.*, at 440. Deduction of an unpaid expense by an accrual-basis taxpayer, Justice Stone continued, is necessary when "all the events" have occurred which "fix the amount" of an expense and "determine the liability of the taxpayer to pay it." *Id.*, at 441.

As Justice Brandeis wrote later, the all-events test is "a practical, not a legal, test" which allows deduction of "*losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduction . . . before they are absolutely realized.*" *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930) (emphasis added). As an example, in *American National Co. v. United States*, 274 U.S. 99 (1927), the Court allowed an accrual-basis taxpayer to deduct bonuses payable to investors over the next five years.

In this case, at the close of the tax year the casino licensee has a definite obligation to pay the progressive jackpot amount in the future. By state order, the casino cannot turn back or reduce the jackpot amount, nor can a New Jersey casino change the odds on any progressive slot machine. Indeed, the payout on slot machines in Atlantic City is set by law at no less than 83 percent.

The fixed quality of the accrued jackpot may be illustrated by viewing that obligation in different contexts. Any party purchasing a casino property would have to recognize the accrued progressive jackpots as a liability to be assumed. A license applicant could hardly expect the Commission to award a license to an applicant that intended to repudiate pre-existing progressive jackpot obligations. In addition, if a casino license is suspended or revoked, the Commission may appoint a conservator who would assume "any and all valid liens, claims, and encumbrances," N.J. Stat. Ann., §5:12-130.2, plainly including the progressive jackpots. *Compare* Nev. Rev. Stat. §463B.130 (supervisor appointed under Nevada law assumes "liens, claims and encumbrances" against gaming establishment). Indeed, one Atlantic City licensee recently sought protection under Chapter 11 of the federal bankruptcy laws, but its operations — including progressive slot machine jackpots — have continued.[7]

Of course, as the government pointed out in its Reply Memorandum to the opposition to the certiorari petition (p. 3) the government's position is not based on the remote possibility that a casino might go bankrupt and fail to pay accrued progressive jackpots.

> Remote contingencies like bankruptcy, which might serve to divest respondent of its obligation on liabilities once they have become fixed, are properly regarded as "conditions subsequent." It is well settled that conditions of the latter sort do

7. *See* "Elsinore Late With Interest," Atlantic City Press, Jan. 16, 1986, p. 1, col. 1.

not preclude accruals under the "all events" test, and we are not contending otherwise.[8]

What is left of the government's argument, then, is the fact that at the close of the tax year no individual can assert a claim to the progressive jackpot. It is on this fact alone that the government's position succeeds or fails.

The "all events" test has never included a requirement that the ultimate payee be identified before an obligation is "so reasonably certain in fact" as to be deductible. The Treasury Regulations require only that "all the events have occurred which determine the *fact* of the liability" and that "the amount thereof can be determined with reasonable accuracy." 26 C.F.R. 1.461-1(a)(2) (1985) (emphasis added). Nothing in the regulation or in any prior decision requires that the identity of the payee also be established

It is surely an unusual case in which the fact of liability can be established without knowing the identity of the payee. But the extraordinary and pervasive regulation of the casino industry creates just such unusual circumstances with respect to liability for progressive jackpots. The practical test required for the all-events test establishes that the casino's liability for the progressive jackpot is fixed. As the Court of Claims held in allowing deduction of accrued contributions to a profit-sharing plan even when the identity of the ultimate recipients was not known, "it is the certainty of the liability which is of utmost importance in the 'all events' test, and not necessariiy either the certainty of the time over which payment will be made or the identity of the payees." *Washington Post Co. v. United States*, 405 F.2d

8. Similarly, the Ninth Circuit has held that a Nevada casino which was an accrual-basis taxpayer had to report as accrued income all "markers" held from patrons, even though the casino would not be able to collect on all of those markers. *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387, 1390-91 (9th Cir.), *cert. denied*, 459 U.S. 1036 (1982).

1279, 1284 (Ct. Cl. 1969). Because state regulations establish with a reasonable certainty the fact of a casino licensee's liability to pay progressive slot machine jackpots, the accrued liability for those jackpots is deductible under the "all events" test even though the identity of the payee is unknown.[9]

9. The balance of the government's arguments are essentially makeweights. *First*, the 1954 statute concerning accrued deductions was repealed in 1955 at the request of the Secretary of the Treasury, who agreed that the repeal would "operate simply to reestablish the principles of law which would have been applicable if [the statute] had never been enacted." H.R. Rep. No. 293, 84th Cong., 1st Sess. 5 (1955); *see* S. Rep. No. 372, 84th Cong., 1st Sess. 5-6 (1955). *Second*, that tax accounting and financial accounting sometimes diverge is scarcely a matter for celebration, but is an unfortunate development to be avoided, if possible. As Justice Stone noted concerning the predecessor to §446, the purpose of that provision was to allow taxpayers to prepare tax returns "made on the basis on which the taxpayer's books were kept," including the accrual basis. *Anderson, supra*, 269 U.S. at 439; *see Eastman Kodak Co. v. United States*, 534 F.2d 252, 258 (Ct. Cl. 1976), ("our goal should be to reconcile business and tax treatment of an item, rather than to drive them farther apart"). *Third*, the government's dark references to possible "tax avoidance" schemes are unsupported in this record and unrealistic in view of the strict state regulations outlined above.

CONCLUSION

For all of the foregoing reasons, the decision below should be affirmed.

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APPENDIX OF STATUTES AND REGULATIONS

New Jersey Statutes Annotated, §5:12-100(e):

All gaming shall be conducted according to rules promulgated by the commission . . . . Each slot machine shall have a minimum payout of 83%.

New Jersey Administrative Code, §19:45-1.39, Progressive Slot Machines:

(a) This section shall apply to any slot machine with a "progressive meter(s)" that increases as the machine is played.

(b) Unless otherwise authorized by the Commission, each progressive slot machine in a casino shall have the following identifying features:

1. A mechanical, electrical or electronic device, to be known as a "progressive meter(s)", visible from the front of the machine which increments at a set rate of progression with coins placed into the machine, and which advises the player of the amount which can be won if the progressive jackpot combination appears;

2. A mechanical, electrical or electronic device, to be known as a "progressive jackpot meter" that is visible without opening the door and that continuously and automatically records the number of times a progressive jackpot is hit;

3. A separate key and key switch to reset the "progressive meter(s)" or such other separate reset mechanism as may be approved by the Commission;

4. A separate key locking the compartment housing the progressive meter(s) or other means by which to preclude any unauthorized alterations to the progressive meters.

(c) Unless otherwise authorized by the Commission, each progressive slot machine connected to a common progressive display unit shall:

1. Be of the same denomination and have the same probability of hitting the combination that will award the progressive jackpot as every other machine connected to such display unit;

2. Require that the same number of coins be inserted to entitle the player to a chance at winning the progressive jackpot and each coin shall increment the meter(s) by the same rate of progression as every other machine connected to such display unit; and

3. Have its microprocessor or other control unit that controls the common display unit housed in a location which would allow dual key control of the Commission and the casino licensee, or with such other key controls as the Commission may approve.

(d) Every casino seeking to utilize a progressive slot machine connected to a common progressive display unit shall submit to the Commission for approval the location and manner of installing the common progressive display unit.

(e) No progressive slot machine shall be placed on the casino floor until the casino licensee has submitted to the Commission and the Commission has approved the following:

1. The initial and reset amounts at which the "progressive meter(s)" will be set;

2. The proposed system for controlling the keys and access codes to these machines; and

3. The proposed rate of progression for each machine;

(f) No "progressive meter(s)" shall be turned back to a lesser amount unless the amount indicated has been

actually paid to a winning patron, or the progressive jackpot amount won by the patron has been recorded in accordance with an approved system of internal controls, or the change in the meter(s) reading is necessitated by a slot machine or meter(s) malfunction, in which case an explanation must be entered on the Progressive Slot Summary required in (j) below and the Commission inspector must pre-approve the resetting in writing.

(g) Once an amount appears on a "progressive meter(s)", the rate of progression and the probability of hitting the combination that will award the progressive jackpot may not be changed until there has been a winner of the payout amount registered on the meter(s) or the payout limit, as described in subsection (i) of this section, is registered on the "progressive meter(s)".

(h) If the "progressive meter(s)" progresses without a payout until the meter(s) returns to zero because of digital limitations on the meter(s), some means must be utilized to clearly advise the patrons of the value of the undisplayed digit.

(i) The payout limit, if any, shall be posted on the slot machine and shall be clearly visible to the patron.

(j) The amount indicated on the "progressive meter(s)" and "in meter" on each slot machine shall be recorded on a Progressive Slot Summary, at a minimum, once each day and such summary shall be signed by the preparer. Supporting documents shall be maintained to explain any reduction in the registered amount from the previous entry and shall indicate the date, casino number of the slot machine, and the amount of the reduction.

(k) Unless otherwise authorized by the Commission, a progressive slot machine removed from the gaming floor shall be returned to or replaced on the gaming floor within five days. The amount on the "progressive meter(s)" on the returned or replacement machine shall not be less than the amount on the "progressive meter(s)" at the time of removal. If the machine is not returned or replaced, then the "progressive meter(s)"

amount at the time of removal shall be added to like machine or machines as approved by the Commission.

New Jersey Administrative Code, §19:46-1.30, Disciplinary Procedures:

(a) Any changes or modifications found in a slot machine that have not been approved by the commission in advance, or any circuitry of any kind or manner which changes or alters the manner of operation from that which was approved by the commission or has been represented to the public, or any other circuitry changing or altering the manner and mode of operation that was not discovered by the division or commission at the time of licensing the machine or any other violation of these regulations shall constitute cause for sealing or seizing any or all of the slot machines manufactured, distributed or utilized by a licensee and further shall constitute cause for limiting, conditioning, restricting, suspending or revoking the license of the licensee or fining said licensee.

(b) Prior to seizure of all machines of a manufacturer, distributor or operator pursuant to subsection (a), a reasonable effort may be made to determine if the change has occurred in all or in part of the machines and may provide the opportunity for an investigative hearing. In any case in which seizure may be effected prior to the opportunity for a hearing, an investigative hearing must be conducted as soon as practical subsequent to the seizure.

(8)

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In the Supreme Court

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United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner
v.
HUGHES PROPERTIES, INC.,
Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF OF TRANSAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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No. 85-554

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner
v.
HUGHES PROPERTIES, INC.,
Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF OF TRANSAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

PRELIMINARY STATEMENT

Transamerica Corporation ("Transamerica") submits this brief as *amicus curiae* in support of Respondent in this proceeding. All parties to this proceeding have given their written consent to the filing of this brief. Copies of such written consents have been filed with the Clerk of the Court.

INTEREST OF AMICUS CURIAE

Transamerica, a diversified insurance and financial service company, files a consolidated federal income tax return annually on behalf of itself and all members of its affiliated group. Transamerica and over 150 members of its affiliated group calculate their income on the accrual method of accounting. Neither Transamerica nor any member of its affiliated group operates casinos. However, like Respondent, Transamerica has had and currently has disputes with the Commissioner of Internal Revenue and the United States over the proper application to Transamerica's tax returns of the accrual method of accounting. One such dispute is currently pending in both the United States District Court for the Northern District of California and the United States Tax Court. *Transamerica Corporation v. United States*, Nos. C-84-0877 TEH and C-85-2543 TEH (N.D. Ca.); *Transamerica Corporation v. Commissioner*, Docket Nos. 16460-79, 5909-82 and 29985-83 (United States Tax Court).

SUMMARY OF ARGUMENT

Under the accrual method of accounting, taxpayers report income and take deductions not when they receive or make payment but when they obtain a right or incur an obligation. Congress authorized taxpayers to use the accrual method of accounting because it provides a clearer reflection of taxpayers' income than does the cash method. I.R.C. § 446(c); *United States v. Anderson*, 269 U.S. 422, 440 (1926). The accrual method of accounting accomplishes this goal by allowing taxpayers to use "scientific accounting principles" to charge "against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *Id.*

Transamerica files this *amicus curiae* brief because the position of the United States, particularly that expressed at pages 19-29 of the Brief for the United States ("Br."), if accepted by this Court, would fundamentally alter the accrual methed of accounting, converting it from a method which seeks to match in each taxable year the revenues and related expenses of a taxpayer to a hybrid method of accounting, part accrual and part cash, in which the Commissioner of Internal Revenue (the "Commissioner") will have discretion to distort taxpayers' income in order to increase the government's revenues. Petitioner's position is inconsistent with the purposes of the accrual method of accounting, with good accounting practice and with the reasoning of this Court in its prior decisions in analogous areas of the Internal Revenue Code. *See, e.g., Commissioner v. Idaho Power Company*, 418 U.S. 1 (1974).

Transamerica urges this Court to rule for Respondent. Petitioner argues that Respondent's deduction of its progressive slot machine liabilities does not clearly reflect income under Section 446(b) of the Internal Revenue Code because Respondent allegedly has not met the "all events" test set forth in Treasury Regulations §§ 1.446(c)(1)(ii) and 1.461-1(a)(2). Respondent, however, has demonstrated that it satisfies the "all events" test because the Nevada Gaming Commission imposes upon it an unconditional liability to pay the amounts showing at year end on the payoff indicators of its progressive slot machines. Respondent has also demonstrated, through uncontradicted expert testimony, that its method of accounting properly matches its income and expenses and, in the words of this Court in *Commissioner v. Idaho Power Company*, "comports with accounting and taxation realities." 418 U.S. at 10. In close cases under the "all events" test, the Internal Revenue Code, by

explicitly sanctioning the accrual method of accounting, suggests that this Court should look to such accounting and taxation realities to determine whether the Commissioner has properly concluded that the taxpayer's method of accounting does not clearly reflect its income under Section 446(b). Respondent has shown that its accounting method matches its income and expenses precisely: As gamblers deposit coins into progressive slot machines, the casino recognizes income. Simultaneously and automatically, the expenses attributable to the earning of that income are registered on the progressive slot machine indicator to be deducted as the related income is recognized. Petitioner offers no concrete evidence to suggest that Respondent's deduction of its progressive slot machine liabilities distorts its income. In the absence of such evidence, Petitioner cannot disallow Respondent's deductions.

ARGUMENT

I. Respondent Met The "All Events" Test At The Time It Deducted Its Progressive Slot Machine Liabilities.

Petitioner argues that Respondent fails to meet the "all events" test largely because until a gambler makes a winning pull no single gambler could make a claim against Respondent as a result of its progressive slot machine liability and because Respondent could avoid payment of this liability if it ceased its casino operations before the winning pull. (Br. 11-13) If Petitioner is to prevail, it can only be because the absence of a specific gambler who can make a claim or the ability of Respondent to avoid a claim by closing its casino prevents Respondent from establishing the fact of liability under the "all events" test.

Petitioner's application of the "all events" test to the facts of this case, however, focuses on the wrong relationship. The relationship between the casino and the lucky gambler who makes the winning pull does not create the liability deducted by Respondent. That liability arises from the relationship of Respondent to the Nevada Gaming Commission. The Gaming Commission issued Respondent a license to operate a casino. Respondent, in turn, obligated itself to abide by all Nevada Gaming Regulations. When Respondent places progressive slot machines in service, it does so subject to the liability imposed upon it by Reg. § 5.110 of the Nevada Gaming Regulations. Joint Appendix (hereinafter "J.A.") 56. Under Reg. § 5.110, Respondent may not turn back the payoff indicator on its progressive slot machines and may not remove them from the floor without transferring the amounts to other machines until the amount showing on the payoff indicator has been won. J.A. 55-57. If Respondent violates this regulation, the Nevada Gaming Commission can fine it or suspend or revoke its license. J.A. 53-55. Unless it ceases its casino business, Respondent cannot avoid payment of this liability. The winning pull of the slot machine merely identifies the time of payment and the identity of the payee of this liability.

Liabilities similarly imposed by governmental regulation have been recognized as properly deductible by numerous courts construing the "all events" test, even in circumstances where the specific payee or time of payment cannot be determined. *Harrold v. Commissioner*, 192 F.2d 1002, 1004-06 (4th Cir. 1951); *Denise Coal Co. v. Commissioner*, 271 F.2d 930, 934-37 (3d Cir. 1959); *see also Haynsworth v. Commissioner*, 68 T.C. 703, 712 (1977), *aff'd*, 609 F.2d 1007 (5th Cir. 1979). The fact that as of the end of the tax year no gambler yet had a legally enforceable right to collect the jackpot is irrelevant; legal

enforceability is not a prerequisite to fixing the fact of liability under the "all events" test. *Eastman Kodak Co. v. United States*, 534 F.2d 252, 257 (Ct. Cl. 1976); *cf. Barker v. Magruder*, 95 F.2d 122, 123 (D.C. Cir. 1938); *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926, 934-36 (D. Nev. 1980), *aff'd*, 664 F.2d 1387 (9th Cir. 1982); *see also United States v. Anderson*, 269 U.S. 422 (1926) (holding that taxpayer should have deducted its liability for a tax the year before the tax was assessed).

Nevada law concerning the enforceability of gambling debts demonstrates the faulty logic of Petitioner's contention that when the only sanction on the casino is the threat of loss of its license the "all events" test cannot be met. Petitioner concedes that once a gambler makes a winning pull Respondent may deduct the amount showing at the time of the pull on the payoff indicator. (Br. 15) Under Nevada law, however, the winning gambler cannot enforce the debt against the casino. *Corbin v. O'Keefe*, 87 Nev. 189, 484 P.2d 565 (1971) (per curiam); *Weisbrod v. Fremont Hotel, Inc.*, 74 Nev. 227, 326 P.2d 1104 (1958) (per curiam); *Flamingo Resort, Inc.*, 485 F. Supp. at 930. If the casino refuses to pay, the gambler must pursue administrative remedies through the Nevada Gaming Commission, J.A. 71-72, which has powers to sanction the casino for failure to pay identical to those it has to sanction the casino if the casino prematurely removes a progressive slot machine from play. J.A. 59; *Weisbrod*, 326 P.2d at 1104-05. The winning pull in no way alters Respondent's liability; it merely identifies the time for payment and the payee. The "all events" test, however, does not require an accrual basis taxpayer to wait until the time of payment has been identified to deduct a liability. *Eastman Kodak Co.*, 534 F.2d at 258; *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 405-06 (5th

Cir. 1969). Nor does it require that the payee be specifically identifiable. *Denise Coal Co.*, 271 F.2d at 936.

The theoretical possibility that Respondent may avoid payment of its liability by ceasing operation of its casino similarly does not alter the fact that its liability is fixed when it places its progressive slot machines in operation. Any accrual basis taxpayer may go out of business before paying its liabilities. The courts have consistently held that the possibility that a taxpayer will go out of business cannot prevent the taxpayer from establishing the fact of liability under the "all events" test. *See, e.g., Lawyer's Title Guaranty Fund v. United States*, 508 F.2d 1, 6 (5th Cir. 1975); *Eastman Kodak Co.*, 534 F.2d at 260, n.12. Any other holding would destroy the accrual method of accounting. *Id.* Moreover, if the Commissioner had had evidence that a real risk existed at the end of any tax year that Respondent would avoid payment of its liability by ceasing its casino operations, the Commissioner could have disallowed the deduction even though Respondent met the "all events" test. *Mooney Aircraft, Inc.*, 420 F.2d at 410.[1]

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[1] *Mooney Aircraft, Inc.* also disposes of Petitioner's contention that Respondent fails to meet the "all events" test because of its discretion to set the slot machine odds so that the slot machines will be unlikely to pay off for many years. (Br. 12) Any taxpayer can negotiate its contracts so that its liabilities will be payable only many years in the future. *Mooney Aircraft, Inc.* held that the length of time before payment is not a factor under the "all events" test. *Id.* at 405-06.

Mooney Aircraft, Inc., however, does not leave the Commissioner powerless to deal with attempts to manipulate the tax laws by deducting expenses which will not be paid for many years. That case upheld the Commissioner's disallowance of a deduction of an expense not likely to be paid for 20 or 30 years despite its holding that the taxpayer met the "all events" test. *Id.* at 409-10. The court held that,

II. The Courts Below Properly Gave Substantial Weight To Respondent's Uncontroverted Evidence That Its Accounting Method Complies With Generally Accepted Accounting Principles.

1. Transamerica does not operate casinos. What troubles Transamerica more than Petitioner's misapplication of the "all events" test to the facts of this case is that Petitioner advocates an approach for solving accrual questions (specifically, for determining when an accrual basis taxpayer may claim a deduction for an expense it has not yet paid) which would gut the only principles used by this Court, in analogous areas, and by the lower courts to resolve accrual questions in close cases. (Br. 19-29)

Petitioner's repeated exhortations that a liability must be "fixed and absolute," "unconditional" and "final and definite" (Br. 11) contribute little or nothing to the resolution of close cases under the "all events" test. This Court, however, should resolve close technical questions of accrual accounting, as it has done in analogous areas of the tax law, primarily by considering whether the accounting method proposed by the taxpayer comports with accounting and taxation realities by properly matching the taxpayer's income and expenses in each taxable period. *See, e.g., Commissioner v. Idaho Power Company,* 418 U.S. 1 (1974). In determining whether the taxpayer's method properly matches its income and expenses, the Court should rely heavily on the financial accounting principles which are the foundation of the accrual method of accounting. *United States v. Anderson,* 269 U.S. at 440; *see also Commissioner v. Idaho Power Company,* 418 U.S. at 12-15. If, as in this case, the method of accounting adopted by the taxpayer properly matches income and expense, this Court should allow the deduction, unless the Commissioner or the United States can point to specific evidence, on the facts before the Court, which suggest that the accounting method employed by the taxpayer distorts the taxpayer's income. Since no such evidence exists here, Respondent should prevail.

The Claims Court and the Federal Circuit in the decisions below appear to have followed exactly this logic. The courts below gave particular emphasis to the principles of financial accounting applicable to Respondent in deciding whether Respondent had met the "all events" test. Respondent presented uncontradicted expert testimony that its method of accounting for progressive slot machine liabilities conforms to generally accepted accounting principles. J.A. 68-69.[2] The Claims Court, after receiving that evidence, found not only that Respondent's liability for the progressive jackpots was fixed by state law at the close of its tax year, but also that a contrary result would mismatch Respondent's income and expenses and in effect would convert Respondent "from an *accrual* basis taxpayer to a *cash* basis taxpayer." *Hughes Properties, Inc.*

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in the circumstances of that case, the Commissioner had properly determined that the taxpayer's method of accounting did not clearly reflect its income. *Id.* Under *Mooney Aircraft, Inc.*, the Commissioner thus could have disallowed Respondent's deduction on the ground that Respondent's method of accounting did not properly reflect its income under Section 446(b) of the Code if the Commissioner had had evidence that Respondent set its slot machines so that a winning pull would be unlikely to occur for many years. *Id.*; *see also Burck v. Commissioner*, 533 F.2d 768, 772 (2d Cir. 1976); *Clement v. United States*, 580 F.2d 422, 430 (Ct. Cl. 1978) (per curiam), *cert. denied*, 440 U.S. 907 (1979).

[2] *See also* Audit and Accounting Guide Prepared By The Gaming Industry Special Committee of the American Institute of Certified Public Accountants, "Audits of Casinos" (1984), at pages 11-12.

v. United States, 5 Cl. Ct. 641, 645 (1984) (emphasis in original). The court of appeals affirmed, stating:

> The taxpayer's method of accounting accurately reflects the casino's income and expenses. If we were to require that the deduction of a jackpot liability be deferred until the year of actual payment, rather than the year in which the liability accrued, it would distort taxable income for the year of payment. Here, the accounting method used by taxpayer results in allocation of the expense to the year in which the revenues were earned.

Hughes Properties, Inc. v. United States, 760 F.2d 1292, 1293 (1985).

Rather than applaud this practical approach to the problem, Petitioner criticizes this reasoning as ignoring the distinction between tax and financial accounting, a distinction it calls critical to a proper understanding of the role of the "all events" test in the law.[3] (Br. 20) However, it is Petitioner, and not the courts below, which misperceives the function of the "all events" test. The "all events" test is a tool to enable the Commissioner and the

[3]The Commissioner apparently does not share Petitioner's view of the distinction between tax and financial accounting. In *Orange & Rockland Utilities, Inc. v. Commissioner*, 86 T.C. No. 14, Tax Ct. Rep. (CCH) Dec. 42,884 (February 18, 1986), the Commissioner rejected an accrual basis taxpayer's non-recognition of income solely because the taxpayer recognized the same income for financial accounting purposes. The Commissioner allowed similarly situated taxpayers not to recognize the income so long as they also did not recognize the income for financial accounting purposes. The Commissioner argued that the taxpayer's recognition of the income for financial accounting purposes made its non-recognition of the same income for tax purposes an improper accounting method which the Commissioner could reject as not clearly reflecting income under Section 446(b) of the Code.

courts to implement, without serious risk to the public fisc, Congress' express desire to permit taxpayers to take advantage of scientific accounting principles in making their returns to achieve a better matching of income and expense than can be achieved by use of the cash method of accounting. *United States v. Anderson*, 269 U.S. at 440. The "all events" test does not override that goal but rather should be construed to the maximum extent feasible to further Congress' goal. *See, e.g., Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl. 1976) (per curiam), *cert. denied*, 429 U.S. 867 (1976); *W.S. Badcock Corp. v. Commissioner*, 491 F.2d 1226 (5th Cir. 1974); *Artnell Company v. Commissioner*, 400 F.2d 981 (7th Cir. 1968).

2. The "all events" test derives from, and can only be understood in the context of, Congress' decision to authorize taxpayers to use the accrual method of accounting for purposes of calculating their federal income tax. Under an accrual method, taxpayers report income and take deductions not when they receive or make payment but when they obtain a right or incur an obligation. Congress first authorized use of the accrual method in 1916 when it became evident that the cash method of accounting "could seriously distort income — especially in a business of any complexity in which payment is frequently received in a different accounting period than that in which expenses attributable to such payment are incurred." *Mooney Aircraft, Inc.*, 420 F.2d at 403. The accrual method provides a clearer reflection of the taxpayer's income than does the cash method, "enabl[ing] taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *United States v. Anderson*, 269 U.S. at 440. The "very essence" of

these scientific principles of accrual accounting, now known as generally accepted accounting principles, is the proper matching of related items of the taxpayer's income and expense in the same accounting period. McClure, *Diverse Tax Interpretations of Accounting Concepts,* 142 J. Acct. 67, 71 (Oct. 1976).

The Internal Revenue Code implements Congress' choice by requiring a taxpayer to compute taxable income "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." I.R.C. § 446(a). Taxpayers may use the accrual method. I.R.C. § 446(c)(2). If the taxpayer regularly uses no method of accounting, "or if the method used does not clearly reflect income," taxable income shall be calculated "under such method as, in the opinion of the Secretary, does clearly reflect income." I.R.C. § 446(b). The Commissioner has stated:

> *A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business* in accordance with accepted conditions or practices in that trade or business *will ordinarily be regarded as clearly reflecting income*, provided all items of gross income and expense are treated consistently from year to year.

Treas. Reg. § 1.446-1(a)(2) (emphasis added). Absent a countervailing tax policy, an accrual basis taxpayer claiming a deduction for an expense it has not yet paid should be allowed the deduction if that deduction reflects the consistent application of generally accepted accounting principles to the taxpayer's trade or business. *See Eastman Kodak Co.*, 534 F.2d at 258.

When a taxpayer uses an accrual method of accounting, however, it confronts the courts and the Commissioner

with a problem not posed by a cash basis taxpayer — the courts and the Commissioner must be convinced that the expense, although not yet paid, is sufficiently certain to be paid that the taxpayer should be allowed to deduct it. If deduction is proper only when payment of the expense is certain, the clearer reflection of income produced by the "scientific principles" of accrual accounting is lost. On the other hand, if deduction is proper in every instance in which the taxpayer reflects the expense in its books, the government's ability to raise money becomes subject to the unfettered discretion of taxpayers.

In *United States v. Anderson*, this Court first addressed this problem, holding that an accrual basis taxpayer should have deducted an unpaid tax on the profits from the manufacture of munitions in the year in which the profits were earned because deduction in that year clearly reflected the taxpayer's income. 269 U.S. at 442. The Court noted that even before the tax was assessed all the events had occurred which fixed the amount of the tax and determined the liability of the taxpayer for it. *Id.* Subsequently, this Court held that accrual basis taxpayers may not deduct an expense unless the events necessary to create the liability occur in the taxable year. *Brown v. Helvering*, 291 U.S. 193, 200 (1934).

The "all events" test constitutes the Commissioner's efforts, derived from *United States v. Anderson* and *Brown v. Helvering*, to crystallize what constitutes clear reflection of income when a taxpayer uses an accrual method of accounting. *Mooney Aircraft, Inc.*, 420 F.2d at 405. Treasury Regulation 1.446-1(c)(1)(ii) states:

> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined

> with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. *The method used by the taxpayer* in determining when income is to be accounted for *will be acceptable if it accords with generally accepted accounting principles*, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

(emphasis added).

The "all events" test could not purport to, and does not, end all the uncertainty inherent in the accrual method of accounting. Uncertainties as to the amount of liability and as to whether the liability will be paid do not preclude the taxpayer from satisfying the "all events" test.[4] *Denise Coal Co.*, 271 F.2d at 935-36. In close cases under the "all events" test, the courts must decide whether the level and character of the uncertainty that the taxpayer will pay the expense justifies the Commissioner's determination that deduction of the expense does not clearly reflect the taxpayer's income.

3. As Treasury Regulation § 1.446-1(c)(1)(ii) illustrates, the "all events" test constitutes a refinement of the scientific principles of accrual accounting designed to protect the public fisc against depletion from deductions

[4]The quote from *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 543 (1979), relied upon heavily by Petitioner (Br. 24), that the tax law "with its mandate to preserve the revenue, can give no quarter to uncertainty," is simply wrong. This Court should take this opportunity to clarify that statement which has misled many courts considering accrual accounting questions. Transamerica will address *Thor Power Tool Co.* in detail in Section III of this brief.

of expense which may never occur. Generally accepted accounting principles, as the scientific accounting principles which first led Congress to authorize use of the accrual method are now called, remain an important guide to what constitutes proper accrual accounting. *Boise Cascade Corp.*, 530 F.2d at 1372. In some circumstances, most particularly those where generally accepted accounting principles require the creation of a reserve for contingent liabilities, this Court has explicitly deviated from financial accounting principles because the level of uncertainty that the expense will be incurred and paid by the taxpayer is simply too great to permit the deduction. *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944) (disallowing deduction for contested tax liability; tax in fact was never paid).

In close accrual accounting cases, however, the "all events" test has proven not to provide any independent rationale for distinguishing between fact situations. Lower courts have, in situations such as these, struggled to find some principled rationale to guide them in determining whether accrual of an as yet unpaid expense would be proper. As the court stated in *Flamingo Resort, Inc.*:

> [T]he courts have not developed a formula that can be applied mechanically to any given fact situation to determine whether accrual is proper or not. Rather the courts have attempted to apply the "all events" test in a manner that recognizes the realities of a given transaction. . . . [W]hether a right is fixed and the amount thereof determinable depends upon "a practical rather than a legal test."

485 F. Supp. at 936 (citations omitted). Other courts have stated that "all events" issues must be viewed "in the light of realism and practicality." *Travis v. Commissioner*, 406 F.2d 987, 990 (6th Cir. 1969), quoting *Commis-*

sioner v. Segall, 114 F.2d 706, 709 (6th Cir.), *cert. denied*, 313 U.S. 562 (1940). Still others have announced that "the proper approach to [an "all events"] problem . . . should be realistic and one that accords with good business practice, rather than an approach based upon subtle technicalities." *Harrold*, 192 F.2d at 1006.

Moreover, commentators have recognized that rigid application of the "all events" test in close cases can produce a mismatching of related revenues and expenses seriously undermining the purpose of the accrual method of accounting, a consequence which has brought such applications into disfavor with Congress, the Service and the courts. Dubroff, Cahill and Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 Alb. L. Rev. 354, 401-02 (1983).

Transamerica believes the answer to this dilemma is clear. The courts should resolve the clear reflection of income question presented in close "all events" test cases by looking to the fundamental purpose of the accrual method of accounting, *i.e.*, the use of "scientific accounting principles" to "charg[e] against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period." *United States v. Anderson*, 269 U.S. at 440.

This Court has recognized in the analogous area of depreciation accounting, where the purpose of the accounting technique is also to match expenditures to the specific accounting period benefitted by those expenditures, that sound accounting principles must be given great weight in resolving technical issues under the Internal Revenue Code. *Commissioner v. Idaho Power Company*, 418 U.S. at 10-16. In that case, this Court held that

a taxpayer must depreciate capital equipment used in the construction of its own capital facilities over the life of the capital facilities constructed rather than over the shorter life of the equipment. In reaching this conclusion the Court relied heavily on financial accounting principles, noting: "Our primary concern is the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities." *Id.* at 10.

The Courts of Appeal, including the court below, have given tremendous weight to evidence that a taxpayer's method of accounting accords with the accounting profession's view of how income should be reflected in that taxpayer's trade or business when determining in accrual cases whether recognition of income or allowance of a deduction clearly reflects the taxpayer's income. *Boise Cascade Corp.*, 530 F.2d 1367; *W.S. Badcock Corp. v. Commissioner*, 491 F.2d 1226 (5th Cir. 1974); *Artnell Company v. Commissioner*, 400 F.2d 981 (7th Cir. 1968); *Pacific Grape Products Co. v. Commissioner*, 219 F.2d 862 (9th Cir. 1955). Numerous other lower courts, in other contexts, have used precisely the same analysis to resolve questions of whether a taxpayer's method of accounting for a particular item clearly reflects its income under Section 446(b). *See, e.g., Transwestern Pipeline Co. v. United States*, 639 F.2d 679, 681 (Ct. Cl. 1980); *Molsen v. Commissioner*, 85 T.C. 485 (1985); *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 286 (1967).

This approach has created no danger to the public fisc. In situations where the "all events" test quite clearly has not been met, the courts have upheld the Commissioner's disallowance of the taxpayer's deduction. *Supermarkets General Corp. v. United States*, 537 F. Supp. 759 (D.N.J. 1982). In closer cases, the courts have been heavily

influenced by financial accounting principles. *See, e.g., W.S. Badcock Corp.,* 491 F.2d at 1228. Where, despite the conclusion that the taxpayer's method of accounting conforms to generally accepted accounting principles applicable to its trade or business, the Commissioner can show, on the specific facts of the case, that payment of the expense will be too remote in time or that no reasonable expectancy exists that the expense will be paid, the courts have held that the Commissioner still has the power to reject the taxpayer's deduction as not clearly reflecting income. *Mooney Aircraft, Inc.,* 420 F.2d at 409-10; *Clement,* 580 F.2d at 430. This approach to technical questions of accrual accounting allows the accrual method of accounting authorized by Congress to survive. It also gives the Commissioner sufficient powers to root out manipulation of the tax laws and prevent any loss to the public fisc from the uncertainty inherent in the accrual method.

This case itself demonstrates that the approach adopted by the lower courts poses no danger to the public fisc. Petitioner puts forward alleged "contingencies" which it concedes are "extremely remote and speculative," arguing that "there is no reason to believe that the odds against their happening . . . differed appreciably from the odds against a customer's winning the jackpot on a progressive slot machine programmed to pay off (say) at 'one chance in 9,725,625.' " (Br. 13) Whether the uncertainty here is an uncertainty as to Respondent's liability itself (as Petitioner argues) or an uncertainty only as to payment (as Transamerica believes), an uncertainty which even Petitioner suggests will occur roughly one time in ten million poses no danger to the public fisc. This Court should not allow Petitioner to sabotage the very underpinnings of the accrual method of accounting sanctioned by Congress to avoid a one in ten million bet. The Commissioner after *Mooney Aircraft, Inc.* has sufficient weapons under Section 446(b) to deal with even that one instance.

4. Congress has also expressed its preference for greater harmony between this area of the tax law and generally accepted accounting principles. In 1954, Congress added sections 452 and 462 to the 1954 Code, permitting accrual method taxpayers to defer the recognition of prepaid income until it was earned and to deduct anticipated expenses not otherwise accruable under the "all events" test. The stated purpose of Congress in enacting these provisions was to bring "[t]ax accounting . . . more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." S. Rep. No. 372, 84th Cong., 1st Sess. 3, *reprinted in* 1955 U.S. Code Cong. & Ad. News 2046, 2048.

The following year, sections 452 and 462 were repealed at the request of the Treasury Department, solely because it was feared that the revenue loss in the transition year would greatly exceed original estimates.[5] Congress made every effort to ensure that the repeal would not be construed as a rejection of financial accounting principles for tax purposes. The Senate Committee report concluded: "[Y]our committee believes that it is essential

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[5]Bersh and Nadel, *The Dilemma of Conformity — Tax and Financial Reporting,* 36 Inst. on Fed. Tax'n, 529, 532 n.7 (1978). Dubroff, Cahill and Norris, 47 Alb. L. Rev. at 361, Cohen, *Accounting for Taxes, Finance and Regulatory Purposes — Are Variances Necessary?,* 44 Taxes 780, 790 (1966). Many commentators now believe that the excessive revenue loss could have been prevented with the use of proper transitional rules. *See, e.g.,* Bersh and Nadel, 36 Inst. on Fed. Tax'n at 532, Kurtz, *A Challenge, Can the Accounting Profession Lead the Tax System?,* 126 J. Acct. 66, 69 (Sept. 1968).

that the income tax laws be brought into harmony with generally accepted accounting principles." S. Rep. No. 372, 84th Cong., 1st Sess. 5, 6, 1955 U.S. Code Cong. & Ad. News at 2051. The House Committee report stated "Your committee is in accord with the general principle that tax accounting should be brought into harmony with generally accepted principles of business accounting since the latter generally reflect more accurately the timing of receipt of income and of incurring of expenses." H.R. Rep. No. 293, 84th Cong., 1st Sess. 3, *reprinted in* 1955-2 C.B. 852, 854.

Congress also expressed its hope that the courts would continue the trend towards harmonizing the tax laws with the generally accepted accounting principles established in *Pacific Grape Products Co. v. Commissioner*, 219 F.2d 862 (9th Cir. 1955) (permitting accrual of anticipated freight and shipping expenses in tax year preceding payment in accordance with the financial accounting practice of the California canning industry) and *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955) (permitting deferral of prepaid subscription income in accordance with the taxpayer's method of financial accounting). Regarding *Pacific Grape Products Co.*, the Senate stated: "An extension of the principles laid down in this case might well lead the courts in the future to permit the accrual of most estimated expenses which would be covered by section 462 even though this section is repealed." S. Rep. No. 372, 84th Cong., 1st Sess. 5-6, 1955 U.S. Code Cong. & Ad. News at 2051. The Secretary of the Treasury informed the House Ways and Means Committee that the "repeal of sections 452 and 462 should operate simply to reestablish the principles of law which would have been applicable if sections 452 and 462

had never been enacted." H.R. Rep. No. 293, 84th Cong., 1st Sess. 5, 1955-2 C.B. at 855.[6]

III. Petitioner's Reliance On *Thor Power Tool Co. v. Commissioner* And *American Automobile Ass'n v. United States* Is Misplaced.

1. Petitioner relies on *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) (*"Thor"*) for the proposition that the goals of financial accounting and tax accounting are too divergent to accord weight to financial accounting principles in this case. However, a closer look at *Thor* reveals that the Court's statements regarding the differences between tax and financial accounting are overbroad and also inapplicable to the facts of this case.

In *Thor*, the taxpayer wrote down "excess" inventory to an estimated below market value based on an "educated guess" that the inventory would not be sold. The write-down, while apparently in accordance with generally accepted accounting principles, was inconsistent with treasury regulations permitting such write-downs only where the inventory concerned was either defective or offered for sale at its reduced value. *Thor* did not involve the application of the "all events" test.

Because the taxpayer in *Thor* did not fall within either of these exceptions, and in fact failed to provide any

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[6]The negative inferences drawn from the repeal of sections 452 and 462 by a five member majority of this Court in *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961), and by Petitioner in this case (Br. 25-26), are flatly contradicted by this legislative history. Indeed, even commentators hostile to the influence of financial accounting principles in the tax law have conceded that the dissent's argument against drawing any such inferences in *American Automobile Ass'n*, 367 U.S. at 704-710, "seems compelling on this point." Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 Va. Tax Rev. 1, 16 n.77 (1984).

objective evidence whatsoever of the reduced value of its excess inventory, the Court held the write-down to be "plainly inconsistent with the governing Regulations" and on that ground rejected it. *Id.* at 533.

Thor presented a glaringly bad fact situation. The regulations permitted the taxpayer to write down its "excess" inventory only if it offered that "excess" inventory for sale and used the bid price to determine its value. Treas. Reg. § 1.471-2(c)(1). Despite having failed to comply with the Regulations, the taxpayer wrote down its excess inventory. It presented no evidence that the value it selected represented the true market value of the "excess" inventory. *Thor,* 439 U.S. at 536. In fact, it continued to sell pieces of its "excess" inventory at prices far higher than the reported value of its inventory on a piece by piece basis. *Id.* To allow the write-down under those circumstances would have been, as the Court put it, tantamount to allowing the taxpayer to "determine how much tax it wanted to pay." *Id.* Unfortunately, however, the blatant facts of the taxpayer's attempted write-down in *Thor,* together with the apparent acceptability of the write-down under the particular financial accounting principles involved in that case, led the Court, in dicta, to make some overbroad generalizations about the weight properly to be accorded to generally accepted accounting principles in every case.

The Court in *Thor* placed great emphasis on the "vastly different objectives that financial and tax accounting have." *Id.* at 542. In fact, as many commentators have observed, the objectives of financial accounting principles and the tax code largely coincide. Dubroff, Cahill and Norris, 47 Alb. L. Rev. at 390; Nolan, *The Merit of Conformity of Tax to Financial Accounting,* 50 Taxes 761, 769 (1972); Kurtz, 126 J. Acct. at 68. Both tax and

financial accounting are directed at achieving the clearest possible reflection of periodic economic income. It is precisely because of this fundamental identity of objectives that Congress directed taxpayers to compute taxable income in accordance with the accounting method used in keeping their books. I.R.C. § 446(a). Were the objectives of tax and financial accounting indeed so "vastly" disparate, the Court in *Thor* could not have stated as it did that "in most cases, generally accepted accounting practices will pass muster for tax purposes." 439 U.S. at 540.

Thor also stressed the conservatism of financial accounting and its purported tendency to understate income, contrasting this with the Treasury's responsibility to protect the public fisc. *Id.* at 542-43. However, while it cannot be disputed that conservatism is a basic component of financial accounting, conservatism does not connote the deliberate, consistent understatement of profits that *Thor* seems to suggest. A company whose stock is publicly held can violate the federal securities laws just as easily by being too pessimistic about its operations as by being too optimistic. *SEC v. Texas Gulf Sulphur,* 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971). Financial accounting principles do not permit deferring recognition of income beyond the time that adequate evidence of its existence becomes available, nor do they justify recognizing expenses before there is adequate evidence that they have been incurred. Financial Accounting Standards Board, Statement of Financial Concepts No. 2: Qualitative Characteristics of Accounting Information, ¶95, *reprinted in* Financial Accounting Standards Board, Accounting Standards, Original Pronouncements as of June 1982 at p. 3064.

In effect, financial accounting's "conservatism" constitutes a check on the natural tendency of those involved in a business to see it through rose colored glasses. Tax accounting's "clear reflection of income" principle operates as a check on the equally natural tendency of those involved in a business not to pay more in taxes than they believe to be absolutely necessary. Both accounting principles, however, have the same objective: to clearly reflect periodic income by charging against income earned in a period the expenses incurred in and properly attributable to the process of earning that income. *United States v. Anderson,* 269 U.S. at 440.

Moreover, the arguments raised in *Thor* were directed at the use of generally accepted accounting principles as a substitute for the specific inventory accounting rules set out in the Code and Regulations, rather than at their use as an aid to the proper application of those rules in close cases. *Thor* did not even address the application of the "all events" test let alone whether financial accounting principles should be given weight in resolving close questions under that test. Where the Commissioner cannot demonstrate with certainty that a taxpayer has failed the "all events" test and where, in addition, payment of the liability is, in the opinion of the accounting profession, so likely to occur that failure to accrue the liability currently will materially distort income, the threat to revenue collection perceived in *Thor* does not materialize. Moreover, the Commissioner's power under Section 446(b) to disallow deductions of expense when specific evidence exists that a taxpayer is unlikely to pay those expenses represents a further guarantee against that threat.

Thor also questioned the suitability of financial accounting principles for tax accounting purposes because these principles do not always provide a single accounting

treatment for each economic event, and because they frequently make use of "estimates, probabilities and reasonable certainties." 439 U.S. at 543-44. However, as commentators have pointed out, this argument "fails to acknowledge the diversity of accounting treatments allowed by the Code, and the number of estimates and subjective judgments required in applying the Code." Dubroff, Cahill & Norris, 47 Alb. L. Rev. at 405 n.158. In the depreciation area, for example, the Code requires the use of estimates based on probabilities to determine the useful life of assets and their salvage value. The valuation of property under various Code provisions also requires estimates and subjective judgments. *E.g.,* I.R.C. § 170 (charitable deductions). In the "all events" area, a reasonable estimate of the amount of an anticipated liability is required, and the question of when a liability has become sufficiently "fixed" to permit its deduction frequently calls for the exercise of judgment. Treas. Reg. § 1.446-1(c)(1)(ii).

The objections cited above to the application of generally accepted accounting principles in the area of tax accounting are particularly inapposite in the instant case. Financial accounting principles do not permit a wide range of permissible treatments for the accrual of anticipated liabilities. Such liabilities may be accrued only where incurrence of the liability is "probable", *i.e.,* when future events confirming the fact of liability are likely to occur. While some exercise of judgment may be required in interpreting the word "probable" under this test, the degree of judgment called for is no greater than that required under the "all events" test in determining when the fact of liability has been established. Moreover, no exercise of judgment whatsoever is required to apply the unambiguous casino accounting rule that progressive jackpots are to be accrued "as the amount of the jackpot

increases."[7] Indeed, the degree of subjective judgment required by the "all events" test far exceeds that required by the applicable financial accounting rule in this case. If the tax law indeed can "give no quarter to uncertainty", *Thor,* 439 U.S. at 543, then the financial accounting rule must be followed here.

Finally, *Thor* made passing reference to the "ability to pay" principle in justifying its refusal to apply a presumption in favor of generally accepted accounting principles. This principle requires that income be reported on receipt, when the taxpayer has the funds to pay. The principle is faulty, because it requires taxpayers to report as income what is really debt capital, thus imposing a heavy and unjustified burden on the financial structure of many taxpayers. Dubroff, Cahill and Norris, 47 Alb. L. Rev. at 405 n. 158.

Closely related to the "ability to pay" argument is the "unrestricted use of funds" argument raised by Petitioner. (Br. 28) Petitioner contends that because Respondent has the "use and enjoyment" of progressive jackpot amounts before they are paid out to a lucky gambler, Respondent, therefore, should be required to pay a tax on these amounts. The argument is specious. Respondent's ability to use the jackpot amounts is irrelevant to the issue of whether they should be taxed. Any taxpayer which borrows money obtains the unrestricted use of funds. Respondent's jackpot amounts represent accrued liabilities. As such these amounts are similar to debt capital, which is properly subject to a "borrower's" "use

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[7]Audit and Accounting Guide Prepared By The Gaming Industry Special Committee of the American Institute of Certified Public Accountants, "Audits of Casinos" (1984), at page 12.

and enjoyment" without any tax first having to be paid thereon.

2. Petitioner concedes that Respondent's method of accounting "results in allocation of the expense to the year in which the revenues were earned" (Br. 24) but contends that proper matching "does not control the outcome here." *Id.* To support this assertion Petitioner relies on a one-line synopsis by the Court in *Thor* of the holding in *American Automobile Ass'n v. United States,* 367 U.S. 687 (1961). *Thor,* citing *American Automobile Ass'n,* states: "a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenues in contravention of 'generally accepted commercial accounting principles'." 439 U.S. at 541. However, this synopsis of *American Automobile Ass'n* is inconsistent with the Court's reasoning in that case.

In *American Automobile Ass'n,* the taxpayer reported income from annual prepaid automobile club membership dues in ratable monthly amounts over the year of membership. In so doing, the taxpayer sought to match the dues income with the anticipated costs of providing the services for which the membership dues had been paid.

The Court rejected this accounting method as "artificial", 367 U.S. at 691, but not, as petitioner suggests, because the Court found matching an irrelevant principle. Rather, the Court found that the taxpayer's accounting method did not match income with related expenses closely enough. *Id.* at 692, 694. The equal monthly installments to which the taxpayer allocated each month's membership dues were "not in fact related to the expenses incurred." *Id.* at 692, 693. This mismatch occurred because, as in *Automobile Club of Michigan v. Commissioner,* 353 U.S. 180 (1957), "substantially all services [were] performed only upon a member's demand and the tax-

payer's performance was not related to fixed dates after the tax year [citation omitted]." *American Automobile Ass'n,* 367 U.S. at 691. Consequently, the expenses incurred in such performance varied considerably from month to month while recognition of income under the taxpayer's method of accounting "nonetheless remain(ed) ratably constant." *Id.* at 693.

American Automobile Ass'n thus held, not that matching is irrelevant in determining the acceptability of an accrual-basis taxpayer's accounting method for tax purposes, but that the taxpayer there had failed to present evidence that its proposed matching clearly reflected its income. The Court rejected an accounting method which gave the taxpayer discretion to choose when it would recognize income because the taxpayer's choice did not demonstrably relate to the time when the expenses associated with the earning of that income would be incurred. The holding in *American Automobile Ass'n* implies that had the accounting method employed by the taxpayer restricted such discretion by requiring a clearer and more direct relationship between the accrual of income and related expenses, it would have been upheld. In fact, subsequent cases have allowed deferral of prepaid income when future services are scheduled for fixed dates or can otherwise be matched with payments on a closer basis. *Boise Cascade Corp.,* 530 F.2d at 1369-70, 1376-78; *Artnell Co.,* 400 F.2d 981.

In the instant case the requirements of *American Automobile Ass'n* are met because there could be no closer matching of related income and expenses, and because no exercise of discretion on Respondent's part is involved. As gamblers deposit coins into progressive slot machines, the casino recognizes income. Simultaneously and automatically, the expenses attributable to the earning of that

income are registered on the progressive slot machine indicator. The matching is demonstrable and exact: The precise cost of earning the income taken in by each progressive slot machine is accrued as the income is earned. Respondent thus eliminates the "artificial" separation of income accrual from the incidence of related expense which so troubled the Court in *American Automobile Ass'n.*

CONCLUSION

Petitioner's contention that Respondent has failed to meet the "all events" test hinges on Respondent's inability to identify a specific gambler who could make a claim and on Respondent's ability to avoid a claim by ceasing its casino operations. For the reasons stated herein, Transamerica Corporation believes this argument is incorrect and urges this Court to affirm the judgment of the United States Court of Appeals for the Federal Circuit.

Respectfully submitted,

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I am a citizen of the United States and a resident of the City and County of Los Angeles; I am over the age of eighteen years and not a party to the within action; my business address is: 1706 Maple Avenue, Los Angeles, California.

On March 3, 1986, I served the within Amicus Curiae Brief in re: "United States of America -v- Hughes Properties, Inc." in the United States Supreme Court, October Term 1985, No. 85-554;

on the parties in said action, by placing 3 copies thereof enclosed in a sealed envelope with postage fully prepaid, in the United States post office mail box at Los Angeles, California, addressed as follows:

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All Parties required to be served have been served.

I certify (or declare), under penalty of perjury, that the foregoing is true and correct.

Executed on March 3, 1986, at Los Angeles, California

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Supreme Court, U.S.
FILED
MAR 1 1986
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No. 85-554

IN THE
Supreme Court of the United States
OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
Petitioner,

v.

HUGHES PROPERTIES, INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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BRIEF *AMICUS CURIAE* OF NEW YORK LIFE INSURANCE COMPANY

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IN THE

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Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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BRIEF *AMICUS CURIAE* OF NEW YORK LIFE INSURANCE COMPANY

This brief in support of respondent is submitted with the written consent of counsel for respondent and the Solicitor General filed with the Clerk of the Court.

INTEREST OF THE *AMICUS CURIAE*

New York Life Insurance Company (the "Company") is a mutual life insurance company required by section 811 of the Internal Revenue Code to utilize the accrual method of accounting for federal tax purposes. While subject to taxation under Subchapter L of the Internal Revenue Code, which applies specifically to life insur-

ance companies, the Company is nevertheless subject to the generally applicable all events test of tax accounting.

The all events test governs the accrual of deductions for tax purposes and is a pervasive principle of tax accounting. The Company applies the test to a broad range of deductions in the determination of its federal income tax liability. In so doing, the Company abides by an interpretation of the test that has long been established by a substantial body of precedent. While the court below has correctly applied the test to the facts of this case, the government contends otherwise and advances a position that sharply departs from the longstanding precedent. Indeed, the broad arguments put forward by the government do violence to the most fundamental precepts of the all events test and would greatly restrict the types of liabilities accruable under that test. Given its substantial utilization of the all events test, the Company faces the threat of significantly increased tax liability if the arguments advanced by the government were to prevail.

The Company is particularly concerned because those arguments go far beyond what is necessary for the Court to resolve this case consistently with the accepted understanding of the all events test. It is hoped that this brief *amicus curiae* will be of assistance to the Court in its evaluation of the government's wide-ranging contentions.

SUMMARY OF ARGUMENT

Proper application of the all events test focuses on whether the taxpayer is subject to an existing liability at year end. In making this determination, it is irrelevant whether such liability is enforceable at year end and, accordingly, whether any person is identified at year end who could at that time assert a claim based upon the liability. The government's contention to the contrary is based upon a misperception of the analysis required under the all events test, and injects into this case a false

issue that is wholly extraneous to the proper resolution of the case.

In applying the all events test, the crucial distinction is whether at year end the taxpayer is subject to an existing liability, which can be created by statutory, regulatory, or contractual obligations imposed on the taxpayer, or whether the taxpayer's liability does not yet exist but is contingent upon the occurrence of future events. In the latter instance, the future events are "conditions precedent" which must occur before a taxpayer's liability can satisfy the all events test. Other future events, which may act to terminate a taxpayer's existing liability, are "conditions subsequent" and do not prevent the accrual of such existing liability. Still other future events have no impact on the existence of liability, but only affect the timing or manner in which that liability is paid or satisfied, or the identity of the ultimate payee, and thus do not affect the analysis of whether a taxpayer's liability satisfies the all events test. These analytical principles are firmly established by the overwhelming weight of precedent. The government's position simply ignores this precedent and thus the rule of stare decisis.

The court below correctly determined that the applicable Nevada Gaming Commission regulation subjected respondent to an existing liability to pay out its year-end guaranteed jackpots, and that any uncertainties surrounding the ultimate timing or receipt of payment of that existing liability were either conditions subsequent or other future events that did not prevent the liability from satisfying the all events test. In reaching a contrary result, the Ninth Circuit in *Nightingale v. United States*, 684 F.2d 611 (9th Cir. 1982), upon which the government places principal reliance, inexplicably failed to consider whether the state regulation created an existing year-end liability. As a result of that failure, the Ninth Circuit was forced to view the winning slot ma-

chine handle pull as a condition precedent to the creation of the taxpayer's liability. Based solely upon this erroneous premise, the Ninth Circuit found that uncertainties surrounding the occurrence of the perceived condition precedent prevented accrual under the all events test.

The decision in *Nightingale* is contrary to established precedent, both generally and in the Ninth Circuit, and should be rejected in favor of the reasoning of the decision below. However, if this Court disagrees, its basis for decision should be limited to the ground that the specific state regulation at issue fails to create an existing year-end liability. Moreover, this Court should limit any holding ascribing relevance to uncertainties surrounding the ultimate timing or receipt of payment to situations in which the underlying liability is subject to a condition precedent and therefore does not exist at year end.

Accrual of respondent's year-end liability for guaranteed jackpots (as opposed to estimates of future jackpots ultimately paid) accurately matches income to expenses and therefore clearly reflects its income. The cases cited by the government in support of its position that the Commissioner has broad powers to determine whether a method of accounting clearly reflects income are not on point because they all involve taxpayers that have attempted to avoid the application of accepted tax accounting principles through the use of estimates of future liability. The opportunities for tax avoidance that the government speculates would be created if the decision below is affirmed simply do not exist, especially since Congress has recently enacted new rules that apply to restrict the accrual of liability under the all events test.

ARGUMENT

I. THE GOVERNMENT'S ARGUMENT MISPERCEIVES THE PROPER FOCUS OF ANALYSIS UNDER THE ALL EVENTS TEST

The all events test was formulated by this Court in *United States v. Anderson*, 269 U.S. 422 (1926). The test is met when all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy. In *Anderson* and subsequent cases, the focus of analysis under the all events test has been on whether at year end the taxpayer is subject to an existing liability. In applying the all events test, the courts have not required that an existing liability of the taxpayer be enforceable at year end by any third party. For example, in *Anderson* itself, a tax liability was held to be accrued in 1916 even though it was not assessed and due until 1917. For an expense to accrue in a taxable year under the all events test, it is only necessary that "a valid obligation to pay must have existed in that year, which is enforceable on the date when the obligation is due." *Helvering v. Russian Finance & Construction Corp.*, 77 F.2d 324, 327 (2d Cir. 1935). A liability accrues under the all events test if at year end it "is so fixed that the fact of liability is certain and the amount thereof reasonably ascertainable, although not necessarily legally enforceable." *Eastman Kodak Co. v. United States*, 534 F.2d 252, 257 (Ct. Cl. 1976).

The government here erroneously ignores the existence of the taxpayer's liability. Instead, the government claims that it is necessary to identify at year end some person who could attempt to enforce the taxpayer's existing liability. By focusing upon the ultimate recipient of payment of the taxpayer's existing liability, the government forsakes established principles of analysis under the all events test and creates a straw man which

draws attention away from the proper inquiry: whether the taxpayer's liability exists at year end.[1]

Viewed in this proper perspective, the decision of the court below fits squarely into the framework of the all events test as established by a substantial body of precedent. Analysis of this precedent demonstrates that respondent's year-end liability to pay guaranteed jackpots satisfies the all events test and that the uncertainties perceived by the government with regard to the ultimate timing, receipt and amount of payment of that liability are irrelevant.

II. THE PARAMETERS OF THE ALL EVENTS TEST HAVE BEEN FIRMLY ESTABLISHED

In applying the all events test, the crucial distinction is whether at year end the taxpayer is subject to an existing liability, or whether the taxpayer's liability does not yet exist but is contingent upon the occurrence of future events. In the latter instance, the future events are "conditions precedent" which must occur before the taxpayer's liability can be accrued. Other future events, which may act to terminate an existing liability, are "conditions subsequent" and do not prevent accrual. Still other future events have no impact on the existence of liability, but only affect the timing or manner in which that liability is ultimately paid or satisfied, or the identity of the ultimate payee, and thus have no impact on accruability.

While the government's argument relies upon cursory analysis and attempts to blur these clear distinctions, the following discussion demonstrates that the distinctions are uniformly recognized in the application of the all

[1] The government creates a straw man in the sense that its position would presumably be the same even if the progressive slot machines involved could be played by only one person so that the identity of the eventual winner of the guaranteed jackpots was established at year end.

events test. Under the government's position, these established all events test principles would simply be ignored and the rule of stare decisis would be violated.

A. Conditions Precedent to the Existence of Liability Prevent Accrual Under the All Events Test

It is well settled that the all events test is not met when the very existence of liability is contingent upon the occurrence of a condition precedent.

Many of the cases relied upon by the government to support its position in this proceeding involve conditions precedent. For example, in *Brown v. Helvering*, 291 U.S. 193, 200 (1934), this Court held that a general insurance agent could not deduct a claimed liability for refunds of commissions that would be due if policies sold by the agent were cancelled in a subsequent year, "since the events [the cancellations] necessary to *create* the liability do not occur during the taxable year" (emphasis added). Similarly, in *Trinity Construction Co. v. United States*, 424 F.2d 302, 305 (5th Cir. 1970), the court held that an employer could not deduct a claimed liability for subsequent years' annual premiums on employee life insurance, since the employer's liability for those premiums did not exist prior to the due dates of the remaining premiums. On similar reasoning, in *Bennett Paper Corp. v. Commissioner*, 699 F.2d 450, 453 (8th Cir. 1983), the court held that an employer could not deduct a claimed liability for contributions to a profit-sharing plan, since the employer's liability did not exist prior to the due dates of the contributions. Finally, in *World Airways, Inc. v. Commissioner*, 62 T.C. 786, 803 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977), the Tax Court stated that the taxpayer could not deduct a claimed liability for overhaul expenses since, until the equipment involved had been operated for "the applicable number of flight-hours, no obligation to overhaul arises."

In each of these cases, the future contingent events were conditions precedent that created, or "fixed," the taxpayers' liability. Thus, in these cases, the taxpayer's liability did not exist at year end, but arose only upon the occurrence of the future event constituting the condition precedent.

B. If the Existence of Liability Is Subject to a Condition Precedent, It Is Irrelevant Whether the Condition Precedent Is Likely to Occur

As a corollary to the principle that contingent liabilities which arise only upon the occurrence of conditions precedent do not satisfy the all events test, it is well settled that the fact that a condition precedent is likely to occur will not serve to establish the liability.

Many cases relied upon by the government involve instances in which taxpayers have argued that the all events test is satisfied because liability is likely to arise. For example, in *Brown v. Helvering*, 291 U.S. at 201, this Court rejected the taxpayer's contention that liability contingent upon the cancellation of insurance policies was established by the fact that "there is a strong probability that many of the policies written during the taxable year will be so cancelled." Similarly, in *Bennett Paper Corp. v. Commissioner*, 699 F.2d at 453, the court refused to allow accrual of a claimed liability despite its recognition of the fact that the condition precedent was likely to occur.

In these and other cases the courts have rejected claims that deductions are accruable based "upon a prediction that liability ultimately might be established." *Kaiser Steel Corp. v. United States*, 717 F.2d 1304, 1307 (9th Cir. 1983). *Accord Milwaukee & Suburban Transport Corp. v. Commissioner*, 18 Tax Ct. Mem. Dec. (CCH) 1039 (1959), *rev'd*, 283 F.2d 279 (7th Cir. 1960), *vacated and remanded*, 367 U.S. 906 (1961), *aff'd on remand*, 293 F.2d 628 (7th Cir. 1961); *Supermarkets General Corp. v. United States*, 537 F. Supp. 759 (D.N.J. 1982).

C. Liability Can Be Created by Statutory and Contractual Obligations

If liability is not subject to a condition precedent, but currently exists, then that liability generally satisfies the all events test. *E.g., American National Co. v. United States*, 274 U.S. 99 (1927).[2] For this purpose, the liability may be created or "fixed" by a statutory, regulatory, or contractual obligation imposed on the taxpayer. This principle is of critical importance in this case.

In its argument, the government largely ignores the fact that this principle exists and is supported by a substantial body of precedent. For example, in *United States v. Anderson*, 269 U.S. 422 (1926), this Court held that a federal tax statute imposed a fixed liability in 1916 even though the tax was not assessed and was not due until 1917. In *Anderson*, this Court held that the *statute* fixed the liability and refused to consider the *assessment* of the tax to be a necessary event.[3] In *Helvering v. Russian Finance & Construction Corp.*, 77 F.2d 324 (2d Cir. 1935), a taxpayer receiving deliveries of mineral ore was obligated by contract to make future payments of a mineral royalty. The court allowed the taxpayer to accrue the liability, stating that: "The liability to pay [a royalty of] $2 by this taxpayer arose

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[2] However, the all events test is not satisfied if the taxpayer contests that liability. *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944); *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944). Congress has specifically addressed the issue of contested liabilities in section 461(f) of the Internal Revenue Code.

[3] The Nevada Gaming Commission regulation and the winning handle pull in this case are directly analogous to the tax statute and the assessment of the tax in *Anderson*.

upon the delivery of the ore, and, in every sense, was properly an accruable item of expense. It was absolute and fixed, in that no further event needed to occur to bring it into existence" (*id.* at 327). Similarly, in *Willoughby Camera Stores, Inc. v. Commissioner*, 125 F.2d 607 (2d Cir. 1942), the court allowed an employer to accrue a liability to pay employee bonuses which was imposed on the employer by an implied contract with its employees and fixed in amount by a board of directors' resolution. In *Champion Spark Plug Co. v. Commissioner*, 30 T.C. 295, 298 (1958), *aff'd*, 266 F.2d 347 (6th Cir. 1959), the Tax Court allowed accrual of a liability established by an "unconditional obligation" created by a board of directors' resolution. Moreover, in *Washington Post Co. v. United States*, 405 F.2d 1279, 1281 (Ct. Cl. 1969), the court allowed a taxpayer to accrue a liability to make contributions to a dealers' profit incentive plan, which had been adopted "without signing any formal contract with individual dealers or with the dealers in aggregate." The court held that the taxpayer was "irrevocably bound [under the terms of the plan] to pay whatever it accrues to the [plan's] Fund" (*id.* at 1283).

The principle that a liability may be created by a statutory, regulatory, or contractual obligation has been recently reaffirmed in the context of workmen's compensation statutes. In *Crescent Wharf & Warehouse Co. v. Commissioner*, 59 T.C. 751 (1973), *rev'd*, 518 F.2d 772 (9th Cir. 1975), the court of appeals held that upon the occurrence of an injury to a worker in the course of employment, the California workmen's compensation law imposes an obligation on the employer and creates an existing liability that satisfies the all events test. *Accord Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983). In *Wien Consolidated Airlines, Inc. v. Commissioner*, 60 T.C. 13 (1973), *aff'd*, 528 F.2d 735 (9th Cir. 1976), it was similarly concluded that upon the

death of an employee, an existing liability is created by the Alaska workmen's compensation law.[4]

The principle has also been established in a series of cases involving supplemental unemployment benefit ("SUB") plans established pursuant to collective bargaining agreements. For example, in *Lukens Steel Co. v. Commissioner*, 52 T.C. 764 (1969), *aff'd*, 442 F.2d 1131 (3d Cir. 1971), the court held that a SUB plan imposed an obligation which created an existing liability to pay future benefits that satisfies the all events test. *Accord, e.g., Crucible Inc. v. United States*, 591 F.2d 643 (Ct. Cl. 1979); *Inland Steel Co. v. United States*, 212 Ct. Cl. 558 (1976); *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943 (1977).

Finally, the principle has been established in a line of cases involving strip mining reclamation statutes. In *Harrold v. Commissioner*, 192 F.2d 1002, 1003 (4th Cir. 1951), the court held that "the contractual and statutory obligation" imposed on the taxpayer to restore and refill land mined during the year created an existing liability that satisfied the all events test. *Accord Denise Coal Co. v. Commissioner*, 271 F.2d 930, 935 (3d Cir. 1959) (the reclamation statute "imposes a fixed and definite obligation"); *Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir.), *cert. denied*, 348 U.S. 828 (1954); *Patsch v. Commissioner*, 208 F.2d 532 (3d Cir. 1953); *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981).

These cases clearly establish that statutory, regulatory, or contractually imposed obligations create year-end liability that is sufficiently certain to satisfy the all events test.

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[4] In *ESCO Corp. v. United States*, 750 F.2d 1466 (9th Cir. 1985), the government did not even argue that the Oregon workmen's compensation statute failed to fix the taxpayer's liability, contending only that the amount of the taxpayer's liability could not be determined with reasonable accuracy.

D. Conditions Subsequent That May Terminate Existing Liability Do Not Prevent Accrual Under the All Events Test

As a corollary to the principle that statutory, regulatory, or contractual obligations can create existing liability sufficient to satisfy the all events test, it is well settled that the existence of "conditions subsequent" that may diminish or terminate an existing liability do not prevent accrual of such a liability under the all events test.

In its brief, the government also ignores the fact that this principle exists and is supported by substantial precedent.[5] For example, in *Helvering v. Russian Finance & Construction Corp.*, the court noted that the contracts provided for contingencies the occurrence of which would terminate the taxpayer's liability to pay royalties, but held that: "The possibility that a present liability may subsequently be discharged by some condition subsequent does not prevent its accrual . . . . A presently existing obligation, which the taxpayer has reasonable grounds to believe must eventually be fulfilled, is not uncertain or contingent in the sense that it may not be accrued" (77 F.2d at 327). *Accord W.S. Badcock Corp. v. Commissioner*, 491 F.2d 1226 (5th Cir. 1974). On similar reasoning, in *Lutz v. Commissioner*, 396 F.2d 412, 414 (9th Cir. 1968), the court held that the fact that a third party was challenging the tax statute under which the taxpayer's liability was imposed, "is too remotely connected with the taxpayer to [cause the court to] describe the [taxpayer's] liability as contingent." In

[5] However, in its Reply Memorandum to respondent's Brief in Opposition (at 3), the government acknowledged that: "Remote contingencies like bankruptcy, which might serve to divest respondent of its obligation on liabilities once they have become fixed, are properly regarded as 'conditions subsequent.' It is well settled that conditions of the latter sort do not preclude accruals under the 'all events' test, and we are not contending otherwise."

Lawyers' Title Guaranty Fund v. United States, 508 F.2d 1, 4 (5th Cir. 1975), the court distinguished "between an imperfect right subject to later perfection, a condition precedent, and a vested right subject to divestment," and held that the all events test is not regarded as "failed merely because a 'condition subsequent' may interfere with actual payment" (*id.* at 6). This distinction was also recognized in *Zwicker Knitting Mills v. United States*, 47 A.F.T.R.2d (P-H) ¶ 81,310, at 81-335 (Ct. Cl. 1980), in which the court held that: "once a liability is properly accrued, the possibility of a subsequent, unexpected event changing its absolute character or discharging payment entirely should not alter its treatment as a fixed liability during the years accrued." *Accord Wien Consolidated Airlines, Inc. v. Commissioner*, 60 T.C. at 15.

Thus, courts have recognized that conditions subsequent do not prevent existing liabilities from satisfying the all events test.

E. Other Events Have No Effect on the Accrual of Liability Under the All Events Test

Other future events may occur that constitute neither conditions precedent nor conditions subsequent. These future events have no effect upon the existence of the liability, but merely upon the timing or manner in which the liability is ultimately paid or satisfied, or the identity of the ultimate payee. Since these events do not affect the existence of liability, they have no effect upon the determination of whether liability accrues under the all events test.

The government relies heavily on these types of future events, failing to note that courts have recognized that year-end uncertainty over the ultimate timing, receipt and amount of payment does not alter the fact that an existing liability is fixed and, thus, does not prevent satisfaction of the all events test. For example, in *Washing-*

ton Post Co. v. United States, 405 F.2d 1279 (Ct. Cl. 1969), the court considered the government's contention that the taxpayer's liability was not fixed for purposes of the all events test because the group of potential recipients "is capable of constant change, and neither the ultimate recipients of the Fund, nor the time of distribution can be ascertained in the year of accrual" (405 F.2d at 1283). The court rejected the government's contention, pointing to "the one overriding reality in this case: plaintiff is irrevocably bound to pay whatever it accrues to the Fund" (*id.*). The court held that "the indeterminancy involved does not make the liability any less real, or any less fixed" (*id.*). *Accord General Dynamics Corp. v. United States*, 6 Cl. Ct. 250 (1984), *aff'd*, 773 F.2d 1224 (Fed. Cir. 1985).

Uncertainty with regard to the ultimate timing, receipt and amount of payment also has been held not to prevent accrual in *Lukens Steel Co. v. Commissioner*, and in the other cases involving liabilities under SUB plans. For example, in *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943, 960 (1977), the court held that "[t]he crucial point is the legal liability to pay someone at some point in time." Similarly, the cases involving reclamation statutes have not required such year-end certainty. In *Ohio River Collieries Co. v. Commissioner*, the court stated that "[t]he fact that the recipients of petitioner's reclamation payments and the relative portions that they would receive were not identified in the tax year is irrelevant" (77 T.C. at 1375). In *Willoughby Camera Stores, Inc. v. Commissioner*, 125 F.2d at 609, the court held the fact that during the year of accrual an employee of the taxpayer could not ascertain his proportionate share of the accrual was not "relevant to the issue of deductibility." Finally, in *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 406 (5th Cir. 1969), the court held that uncertainty over when payment of the liability would occur does not prevent a liability from satisfying the all events test.

Other events which are related solely to the manner in which existing liability is paid or satisfied similarly have no affect on accruability. For example, in *Ohio River Collieries Co. v. Commissioner*, the court explained that there were alternative methods by which the taxpayer's existing liability to reclaim might be satisfied; by performance of the reclamation or by forfeiture of the surety bond that the taxpayer had posted with the state. (77 T.C. at 1375.) The existence of this uncertainty did not prevent accrual of the taxpayer's underlying liability to reclaim. *Accord Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3d Cir. 1959).

III. THE COURTS BELOW CORRECTLY APPLIED THE ALL EVENTS TEST

The courts below correctly applied the all events test to the facts presented and decided the case consistently with the precedent discussed above.

The courts below held that the Nevada Gaming Commission regulation subjected respondent to an obligation sufficient to create an existing year-end liability. The Claims Court thoroughly analyzed the Nevada Gaming Commission regulation and found that under that regulation, "once accumulated, a 'guaranteed' jackpot cannot be lessened or eliminated except by a payoff" (5 Cl. Ct. at 643). The Claims Court held that the regulation created an existing liability (*id.* at 645):

> At the end of plaintiff's fiscal year, plaintiff's obligation to pay out the recorded amount is "unconditionally fixed" by the terms of § 5.110. Under that regulation, the liability for the jackpot amount can be enforced by the Nevada Gaming Commission.

The court of appeals agreed, stating that "[t]he commission regulation makes the guaranteed jackpot a fixed liability" (760 F.2d at 1293). Thus, consistent with the substantial body of precedent discussed above, the courts below held that the applicable state regulation imposed an obligation to pay out the jackpot guaranteed at year end and, therefore, an existing liability.

Moreover, the courts below correctly held that any year-end uncertainty regarding the ultimate timing, receipt and amount of payment does not affect the existing liability created by the state regulation. The Claims Court reasoned that (5 Cl. Ct. at 645):

> The winning handle pull . . . only determines the "fortunate gambler" in whose favor the liability is enforced. That the identity of that "fortunate gambler" is unknown, that the exact time the jackpot will be won is unknown, or that the exact amount of the jackpot at the time it is won is unknown does not affect the certainty of the liability at the end of plaintiff's fiscal year; in other words, "when the liability itself is clearly fixed . . . other uncertainties do not necessarily destroy that initial certainty." Washington Post Co. v. United States, 186 Ct. Cl. 528, 536 (1969).

The court of appeals agreed, holding that: "This liability [created by the regulation] is not contingent upon the time of payment or the identity of the jackpot winner" (760 F.2d at 1293). Thus, the courts below held, consistent with established precedent, that any uncertainties that exist at year end regarding the ultimate timing, receipt and amount of payment of the liability are irrelevant to the issue of whether the liability satisfies the all events test.

In sum, the decisions below are consistent with the established precedent concerning application of the all events test.

IV. THE NINTH CIRCUIT DECISION UPON WHICH THE GOVERNMENT PRINCIPALLY RELIES WAS WRONGLY DECIDED

In *Nightingale v. United States*, 684 F.2d 611 (9th Cir. 1982), the only authority that directly supports the government's position here, the Ninth Circuit incorrectly applied the all events test in a manner that is inconsistent with the established precedent.

While the court in *Nightingale* noted the existence of the Nevada Gaming Commission regulation (684 F.2d at 612-13), that court inexplicably failed to recognize the significance of the regulation and completely ignored it in its analysis of whether the taxpayer's year-end liability satisfied the all events test. Instead, the court held that "the winning of the progressive jackpot by some fortunate gambler" (*id.* at 614) should be regarded "as a condition precedent and not as a condition subsequent" (*id.* at 615) to the taxpayer's liability and, accordingly, that: "Until that event occurs, no actual liability has been incurred" (*id.* at 614).

In reaching this conclusion, the *Nightingale* court simply failed to consider the issue whether the Nevada Gaming Commission regulation imposed an obligation on the taxpayer sufficient to create a year-end liability to pay guaranteed jackpots. Having failed to recognize that the taxpayer's liability was in fact established at year end by state regulation, the court, saddled by this erroneous perception, proceeded to apply the principle that a liability which arises only upon the occurrence of a condition precedent (believed by the court to be the winning handle pull) is not fixed for purposes of the all events test even though the condition precedent is likely to occur (based upon gambling probabilities). Relying upon *Brown v. Helvering* and *World Airways, Inc. v. Commissioner*, the court concluded that "the fact of liability was too contingent to permit accrual" (684 F.2d at 615).

The *Nightingale* court erred in failing to consider the effect of the Nevada Gaming Commission regulation. The court's analysis, which is wholly premised on its failure to consider the state regulation, may be correct insofar as it stands for the proposition that gambling probabilities which make it likely that *nonguaranteed* jackpots will be paid are insufficient to permit accrual

under the all events test. However, the court's analysis ignored the controlling fact: that the casino's liability to pay *guaranteed* jackpots is accruable, not based upon the likelihood that liability will arise when such a jackpot is won, but based upon the existing liability created by the regulatory obligation imposed on the casino to keep the guaranteed jackpot available and to pay out the jackpot when it is won.

Finally, the court in *Nightingale* stated that: "No one can say who will hit the jackpot on that machine, how much it will be when he hits it, or when he will hit it. There are just too many contingencies to permit accrual of the liability as the taxpayers would have us do" (*id.* at 614). In addressing these uncertainties regarding the ultimate timing and receipt of payment, the court premised its analysis on its erroneous belief that the winning handle pull should be regarded "as a condition precedent and not as a condition subsequent" to the existence of the taxpayer's liability (*id.* at 615). Therefore, in emphasizing the significance of these uncertainties, the court was addressing the narrow issue of whether gambling probabilities alone are sufficient to permit accrual of a liability that does not yet exist but which is likely to arise. Since the court failed to consider the question whether the Nevada Gaming Commission regulation established an existing year-end liability, the court did not address the issue whether the uncertainties involved, either as conditions subsequent to that liability or as other future events, could operate to prevent accrual of an existing liability. In other words, because the court did not address the issue whether the Nevada Gaming Commission regulation created a liability which existed at year end, the court never considered whether these types of "uncertainties . . . destroy that initial certainty." *Washington Post Co. v. United States*, 405 F.2d at 1284.

The Ninth Circuit's decision in *Nightingale* is particularly puzzling, since that court has emphatically recog-

nized, both before and after *Nightingale*, that statutory obligations can create liability and that such liability is accruable under the all events test, despite the existence of uncertainties such as those present in *Nightingale*. As previously mentioned, in *Crescent Wharf & Warehouse*, *Wien Consolidated Airlines* and *Kaiser Steel*—all Ninth Circuit cases—the court has held that workmen's compensation statutes act to create liability with sufficient initial certainty to satisfy the all events test. Moreover, in each of those cases, the Ninth Circuit has rejected the government's arguments that various uncertainties regarding ultimate payment are sufficient to destroy that initial certainty. *E.g.*, *Kaiser Steel Corp.*, 717 F.2d at 1306 n.3. On the other hand, in *World Airways*, the Ninth Circuit has recognized that liabilities which come into existence only upon the occurrence of a condition precedent do not satisfy the all events test. In that case, the court rejected the taxpayer's argument that it was subject to a year-end liability created by contractual and statutory obligations, holding that no contractual or statutory obligation existed at year end. *World Airways* is distinguishable from this case, since the Nevada Gaming Commission regulation did impose a year-end obligation.

In *Nightingale*, the Ninth Circuit analogized to *World Airways*, failing to cite or distinguish its own workmen's compensation decisions. This indicates that the Ninth Circuit failed even to consider the possibility that the Nevada Gaming Commission regulation might create an existing liability. This analysis is confirmed by *Kaiser Steel Corp.*, in which the Ninth Circuit distinguished its workmen's compensation decisions from *World Airways* and likened *Nightingale* to *World Airways*, stating that (717 F.2d at 1308 n.6):

> [In *World Airways*] the taxpayer was under no contractual obligation to make any payments unless the engines were actually overhauled. 62 T.C. at 802.

Thus, no obligation to pay ever came into existence. *Id.* at 804. *See Nightingale v. United States*, 684 F.2d 611, 615 (9th Cir. 1982).

The only way to reconcile these cases is to assume that in *Nightingale* the Ninth Circuit completely ignored the operation of the Nevada Gaming Commission regulation.

V. THE ISSUE PRESENTED SHOULD BE RESOLVED ENTIRELY ON THE BASIS OF THE PROPER INTERPRETATION OF THE NEVADA GAMING COMMISSION REGULATIONS

As described above, consistent with established precedent, the court below held that respondent's year-end liability to pay out its guaranteed jackpots is established by the Nevada Gaming Commission regulation, and that any uncertainties that exist regarding the ultimate timing, receipt and amount of payment of that liability do not prevent accrual of the existing liability under the all events test. Respondent properly urges this Court to affirm the decision of the court below on the ground that the Nevada Gaming Commission regulation establishes an existing year-end liability. The court below correctly held that "[t]he commission regulation makes the guaranteed jackpot a fixed liability" (760 F.2d at 1293).

However, if this Court disagrees, its basis for decision should be limited to the ground that the specific Nevada Gaming Commission regulation at issue fails to create a year-end liability to pay out guaranteed jackpots. This Court should not disturb or restrict the general principle that various statutory, regulatory, and contractual obligations imposed on taxpayers create liability with sufficient initial certainty to satisfy the all events test. Indeed, to reject that general principle the Court would be required to overturn a substantial body of precedent.

Respondent also properly urges this Court to affirm the decision of the court below on the ground that any

year-end uncertainties regarding the ultimate timing, receipt and amount of payment do not affect the initial certainty of respondent's liability as created by the state regulation for purposes of the all events test. The court below correctly held that these uncertainties have no effect on respondent's existing liability and do not prevent satisfaction of the all events test.

However, if this Court disagrees that respondent's liability is established at year-end by state regulation, and considers a winning handle pull to be a condition precedent, then it should limit its decision regarding the uncertainties surrounding the ultimate timing, receipt and amount of payment to the effect of such uncertainties as conditions precedent.[6] On the other hand, if this Court agrees that respondent's liability is established at year-end by state regulation, but decides that the uncertainties in issue do prevent satisfaction of the all events test, then it should address in its decision the specific uncertainty or combination of uncertainties it considers to prevent accrual.

VI. RESPONDENT'S METHOD OF ACCOUNTING CLEARLY REFLECTS ITS INCOME

Respondent's method of accounting accurately matches income to expenses and clearly reflects its income. By reporting an expense liability, which satisfies the all events test, in the same year as the income related to that expense, "the accounting method used by taxpayer results in allocation of the expense to the year in which the revenues were earned" (760 F.2d at 1293). If respondent is not permitted to accrue its year-end liability for guaranteed jackpots, its income will not be accurately reflected. For example, if a progressive slot machine is placed in service in July of one year and the jackpot on that machine is won in January of the next year, a

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[6] The government does not contend that conditions subsequent prevent accrual under the all events test. *See supra* note 5.

casino not allowed to accrue its liability would report most of the income related to the jackpot in the first year and all of the expense related to the jackpot in the second year. Such a method of accounting "would distort taxable income" (*id*).

The cases relied upon by the government to support its argument that the Commissioner has broad powers to determine whether a method of accounting clearly reflects income are off point. In those cases, taxpayers have attempted to avoid the application of established principles of tax accounting through use of estimates of future liability. For example, in *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961), this Court rejected a taxpayer's attempt to defer recognition of prepaid membership dues, which ordinarily would constitute income upon receipt,[7] based upon the taxpayer's estimates of when it would render the paid-for services. *Accord, e.g., Schlude v. Commissioner*, 372 U.S. 128 (1963); *Commissioner v. Hansen*, 360 U.S. 446 (1959); *Automobile Club v. Commissioner*, 353 U.S. 180 (1957). In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the taxpayer attempted to write down excess inventory, in a manner "plainly inconsistent" with the applicable Treasury regulations, based not upon "objective evidence" but upon estimates and forecasts prepared by its management (*id.* at 533-35). This Court noted that "Thor's management simply wrote down its closing inventory on the basis of a well-educated guess that some of it would never be sold" (*id.* at 536), and stated that "Thor, in other words, sought a current 'deduction' for an estimated future loss" (*id.* at 542).[8] *Accord, e.g.,*

[7] *See North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932).

[8] *Thor Power Tool* was decided "in the light of the well-known potential for tax avoidance that is inherent in inventory accounting." (439 U.S. at 538.) Thus, that case should be considered in the context of its holding that the Commissioner has broad discretion in the area of inventory accounting.

Brown v. Helvering, 291 U.S. 193 (1934); *Lucas v. American Code Co.*, 280 U.S. 445 (1930).

To the contrary, in the instant case respondent reports its liability in accordance with the proper application of established tax accounting principles; namely, the all events test. Under that test, respondent's liability is established at year end by the Nevada Gaming Commission regulation, and the amount of that liability is determinable with reasonable accuracy. Respondent is not attempting to deduct an amount equal to an estimated future jackpot, but rather only the guaranteed jackpot amount.[9]

Finally, petitioner's reliance on unsupported speculation regarding the potential for tax avoidance is misplaced. The record in this case contains no evidence of untoward manipulation. As the Claims Court stated below, "this court will not hesitate to uphold the Commissioner's efforts to eradicate fraudulent practices, but, where no such practice has been alleged or proven and where the court has found that the timing of the deduction does not distort income, the court will not act on mere speculation" (5 Cl. Ct. at 646). Indeed, the government itself (Br. at 32) has acknowledged that the Commissioner has other weapons in its arsenal to deal with such manipulation were it to arise in the future.

VII. RESPONDENT'S POSITION IS CONSISTENT WITH THE DEFICIT REDUCTION ACT OF 1984

For taxable years subsequent to those involved in this proceeding, Congress has amended the Internal Revenue Code to provide that the all events test is not satisfied

[9] Based upon its own or the industry's experience, respondent may well be able to predict the average amount of guaranteed jackpots when won. However, in this proceeding respondent claims only the precise amount accrued on its progressive slot machines at year end.

until "economic performance" with respect to a liability has occurred. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601; I.R.C. § 461(h)(1). However, this economic performance standard is subject to an exception for certain "recurring items" the accrual of which "results in a more proper match against income." I.R.C. § 461(h)(3)(A)(iv)(II). For purposes of determining whether accrual results in a more proper match against income, "generally accepted accounting principles will be an important factor," and certain evenly accruing expenses (such as insurance or rent expenses) "generally can be allocated to a period and are best matched to that period." Staff of the Jt. Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 264 (Jt. Comm. Print 1984).

In enacting these new provisions, Congress was principally concerned that accrual of deductions under the all events test fails to take into account the "time value of money" (*id.* at 260). Congress was not concerned that courts have misapplied the all events test in too liberal a fashion and expressly recognized that "[a] deduction for contingent liability generally is not allowed under present or prior law" (*id.* at 259). Indeed, in the "recurring item" exception to the "economic performance" requirement, Congress retained much of present and prior all events test law. This is further indication that the broad arguments advanced here by the government are inconsistent with accepted all events test principles.

Moreover, by imposing a new "economic performance" requirement, and by creating a "recurring item" exception, Congress has enacted a statutory scheme that enhances the Commissioner's ability to prevent the type of manipulation and potential for tax avoidance about which the government speculates in its brief. Given the enactment of the "economic performance" test in the

Deficit Reduction Act of 1984, there is no reason for this Court to accept petitioner's invitation to overturn established tax accounting principles in an attempt to prevent other taxpayers from attempting to do what the Internal Revenue Code has already been amended to prevent.

CONCLUSION

The judgment of the United States Court of Appeals for the Federal Circuit should be affirmed.

Respectfully submitted,

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